

Attorney CLE Series



Fraud & Forensic Accounting

**SCHEMES, INVESTIGATIVE TECHNIQUES
AND PREVENTION/DETECTION**

October 9, 2012

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and Assurance & Advisory Services Groups



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena. His expertise in specific purpose valuations is well known, and he is a frequent speaker, regionally and nationally, on tax and valuation matters.

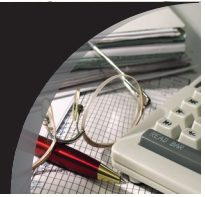
After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

Bob has written numerous articles for several area business publications and professional trade journals. He is a national instructor for both the American Institute of Certified Public Accountants and the National Association of Certified Valuators and Analysts and has served as an adjunct professor for Duquesne University's MBA program.

A member of the American and Pennsylvania Institutes of Certified Public Accountants, Bob previously chaired the Pittsburgh Committee on Taxation. He is also the past chair of the Education Board of the National Association of Certified Valuation Analysts, as well as a former member of the organization's Executive Advisory Board, its highest Board.

He is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the Pittsburgh Chapter of the American Society of Appraisers. Bob has held numerous offices and directorships in various regional not-for-profit organizations. He received the 2003 Distinguished Public Service Award from the Pennsylvania Institute of Certified Public Accountants and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two adult children, Matthew and Alyssa.



Melissa A. Bizyak, CPA/ABV/CFF, CVA



Melissa has practiced in public accounting for over 18 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of professional practices, as well as companies in the manufacturing, oil and gas and technology industries.

These valuations have been performed for a variety of purposes, such as Employee Stock Ownership Plans (ESOPs), marital dissolutions, buy/sell transactions, dissenting shareholder disputes, value enhancement and gift and estate tax purposes.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include membership in the National Association of Certified Valuators and Analysts (NACVA), as well as the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA). She serves on the Board of Directors of the Estate Planning Council of Pittsburgh and is a member of the Robert Morris University Professional Advisory Council.

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of the Leadership Development Initiative, a Leadership Pittsburgh, Inc. program. She serves on the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



Mark D. Wolstoncroft, CPA



Mark has provided audit, accounting and consulting services to businesses in a variety of industries, including manufacturers, service organizations, construction contractors and not-for-profit entities over his 12-year career in public accounting. He provides audit services with a focus on efficiency and with an eye towards additional client service opportunities.

Mark's expertise also includes special project services such as litigation support, buy-side due diligence, forensic investigations, accounting record reconstruction and general business consulting. He has performed special project services for existing clients, private equity firms, attorneys, and other individuals or organizations that desired an independent third party. Mark is committed to providing thoughtful, efficient and value-added special project services and seeks out opportunities to leverage his experience in these areas.

A graduate of Grove City College, Mark earned his B.S. degree in accounting in 2000. Mark is a CPA in Pennsylvania and a member of the American Institute of Certified Public Accountants.

Outside of the office, Mark and his wife, Judi, are committed to serving and supporting a number of nonprofit organizations, including Campus Life, the Greater Pittsburgh Area Food Bank and their local church. Mark currently serves as Treasurer at Bethany Presbyterian Church and on the Audit Committee for the Food Bank. Mark also enjoys organizing an evening golf league focused on professional networking.

Mark and Judi reside in South Fayette Township with their children, Ami Layne and Dean.



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Please contact Mary Lou Harrison to schedule a date: 412-338-9300 or harrison@gyf.com



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Exhibits:

- Sample Fraud Policy – AICPA “CPA’s Handbook of Fraud and Commercial Crime Prevention,” Organizational Code of Conduct
- ACFE Fraud Prevention Checklist

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Introduction

One needs to be only minimally attentive to daily news reports and professional publications to realize that monetary fraud and financial misconduct are common occurrences in today's economic environment. While such practices are extremely "human," with all of the weaknesses and frailties of being human attached, the sheer volume of these activities is stunning. And, the results are misdirecting a huge portion of the nation's economy.

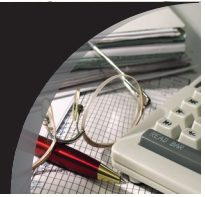
Various types of fraud, perpetrated against individuals, businesses and industries, are prevalent in the United States and are investigated by the Federal Bureau of Investigation (FBI). These include, but are not limited to: corporate fraud, insurance fraud, securities and commodities fraud, misuse of corporate assets or income, money laundering activities, white collar accounting and market manipulation fraud, illegal kickbacks, investment fraud schemes (including Ponzi schemes, pyramid schemes, advanced billing and fee schemes), market manipulation and mass marketing schemes.

The Financial Crimes Section (FCS) of the FBI oversees the investigation of financial frauds and facilitates the forfeiture of assets from those engaging in such illicit activities. To show the breadth of the sophistication of such crimes, the FCS, in fiscal years 2010/2011 was comprised of the Asset Forfeiture/Money Laundering Unit (AF/MLU), the Economic Crimes Unit (ECU), the Health Care Fraud Unit (HCFU), the Forensic Accountant Unit (FAU), the Financial Institution Fraud Unit (FIFU) and the Financial Intelligence Center (FIC).

From dissecting the structure of the Federal Bureau of Investigation and its efforts to address a growing and ever-more-complex menu of fraudulent endeavors, it is obvious that fraud is more widespread and varied than ever before. In today's program, given the limitations of time, focus will turn primarily to understanding, identifying and countering occupational fraud.

By way of definition, the Association of Certified Fraud Examiners (ACFE) defines occupational fraud as, "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."

The ACFE *2012 Report to the Nations on Occupational Fraud and Abuse* is based on data compiled from a study of 1,388 cases of occupational fraud that occurred between January 2010 and December 2011. The information contained and set forth in the study was provided by investigators who worked the cases. This study is international in scope and includes fraud cases from 94 countries. The survey includes some very telling statistical facts illustrating the worldwide effect of fraud, as illustrated on the following page.



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From an impact perspective, the ACFE study notes that:

- The “typical” organization loses 5% of its revenues to fraud each year,
- Applied to the estimated 2011 Gross World Product, the potential projected global fraud loss can be measured at \$3.5 trillion,
- The median loss caused by occupational fraud is \$140,000, with more than 20% of the cases involving losses of at least \$1 million,
- The frauds lasted a median period of 18 months before being detected, and, not surprisingly,
- Occupational fraud is most likely to be detected from an anonymous tip from within the organization than in any other way.

Other interesting aspects of fraud identified in the ACFE report include assessments of victims and perpetrators:

- Occupational fraud is a significant threat to smaller businesses, and in the study, the smallest organizations suffered the largest median losses. Much of this effect is attributable to the failure to employ adequate internal and anti-fraud controls, thus, increasing their specific vulnerabilities.
- Industries most often affected include banking and financial services, government and public administration, and manufacturing.
- Anti-fraud controls are notably correlated with significant decreases in the cost and duration of occupational frauds.
- Nearly half of victim organizations do not recover any losses that they suffer due to fraud.
- As would be expected, perpetrators with higher levels of authority tend to cause much larger losses. Median losses attributable to fraud committed by owners/executives was \$573,000; while fraud caused by managers was \$180,000; and employee fraud medians were just \$60,000.
- The vast majority of perpetrators (nearly 80%) were individuals working in one of six departments: accounting, operations, sales, executive management, customer service and purchasing.
- Most occupational fraud was committed by first-time offenders with clean employment histories.
- In over 80% of the cases, the employee involved in the malfeasance displayed one or more of the behavioral red flags that are often associated with fraudulent conduct. The most prevalent of these characteristics include living beyond their needs (36% of cases), financial difficulties (27%), unusually close association with customers or vendors (19%) and excessive control issues (18%).



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National and international statistics, however, can never seem to bring home the impact of the issue better than our own home-grown perpetrators. The headlines, almost like your favorite music, seem to be synonymous with certain points and times in all of our lives and careers. It is hard to forget these local favorites,

from the WPXI website on December 28, 2011 –

“Ex-Controller Charged in Wexford Car Dealer Fraud”

In this case, which we will discuss briefly in today’s program, the controller was found to have stolen \$10.2 million from an automobile dealership where she had been working for many years. The fraud had taken place over a six-year period. In May, 2012, the perpetrator was sentenced to 6½ years in prison.

from the Pittsburgh Post Gazette, June 20, 2011 –

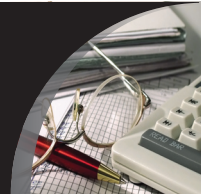
“Le-Nature’s Podlucky Pleads Guilty to Fraud”

In this case, which will be discussed in greater detail later in today’s program, the Company’s CEO, was able to amass over \$800 million in loans that were used to finance extreme personal expenditures and carry on a type of Ponzi scheme for many years, propping up a façade that Le-Nature’s was a profitable business enterprise. He is currently serving a 20-year sentence in federal prison.

While these cases are quick to catch your eye, there are many other cases that occur within our region that fail to gain any publicity, but are just as damaging to investors, lenders and other stakeholders in regional businesses. We have observed or participated in many cases where the victimized entity was never able to fully recover from the traumatic effects of the frauds committed against them.

Today’s program is intended to provide an overview of certain aspects of the Fraud and Forensic practice conducted by the professionals at Grossman Yanak & Ford LLP in identifying, quantifying and alleviating the many stresses imparted upon operating businesses that find themselves the victims of occupational fraud. Moreover, it is our intent to provide certain practice recommendations that might be used to serve as a deterrent to fraud and, hopefully, work to reduce exposure to fraud in the workplace.

Chapter I of these materials will discuss the definition of fraud; better describe the likely victims of fraud and financial malfeasance; and address which employees are most likely to become involved in such activities. We will also describe, therein, those behavioral attributes that might be monitored in all employees to help minimize the impact and ease of becoming involved in fraudulent activities.



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Chapter II will describe many of the common types of occupational fraud, as it might be encountered in operating businesses and not-for-profit organizations. Explanations and examples of each illicit activity will be provided to better allow legal representatives to understand the commission of the fraud.

Chapter III will discuss the mechanics of a fraud assignment and how forensic accounting principles and procedures are incorporated into the process of evaluating the types, breadth and scope of the fraud, as well as quantifying the fraud activity.

Chapter IV will discuss internal control mechanisms designed to mitigate the opportunity for employees to commit fraud, as well as commonly-utilized deterrents intended to add to fraud security at operating companies before fraud can occur.

Chapter V will present actual cases studies of well-documented frauds and financial abuses, including some in which Grossman Yanak & Ford LLP has been involved. Discussion will include how the frauds were identified and the forensic process by which the quantification of those frauds was undertaken. The cases are supplied only as examples and are not intended to be full, self-contained case studies, as they each could take a full day to merely summarize.

The Conclusion simply contains final thoughts on how best to ally the strengths of the legal community and the accounting/fraud community to the benefit of all of our clients.

We do realize that such a complex process cannot be fully explained in a two-hour program, and that you are likely to have further questions. To that end, please contact Bob Grossman, Melissa Bizyak or Mark Wolstoncroft at 412.338.9300. We would be happy to discuss specific case matters or further details about our service capabilities.



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Chapter I – *Overview of Fraud*

Defining Fraud

Perhaps no word conjures up more varied interpretations than the word, “fraud.” Unfortunately, clarifying these interpretations (and sometimes, misinterpretations) is not easily done, as no simple or limited definition of fraud exists.

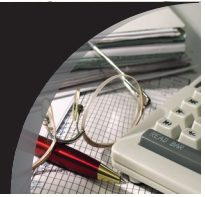
Generally, fraud, as applied in law, is defined by federal and state legislatures and the courts. As most-often used in business and business dealings, fraud simply means an action (or a lack of action) that is punishable by law. Historically, courts have been careful to avoid defining the term fraud, for fear that any definition advanced in the course of legal assessment could result in too strictly and narrowly defining the term and, thereby, limiting its reach in addressing and redressing certain actions.

While it is impossible to develop a single comprehensive definition of fraud, there may be an ability to distinguish between two general types of fraud – that is, a general broad definition and a more narrow criminal one, punishable by law. The common denominator in every definition is some element of dishonesty or deceit. It is this shared attribute that anchors the many similar, but not exactly the same, definitions of fraud that can be found in various statutes, dictionaries, legal treatises, fraud courses and other publications.

Often, in the consideration of fraud, certain phrases and concepts will be encountered. A brief (not intended to be all-inclusive) example of these might include the following:

- Unfair advantage by unlawful or unfair means,
- Knowingly making false representations,
- Intentional deception resulting in injury to another party,
- Intentional and successful employment of cunning, deception, collusion or artifice used to cheat or deceive another person, whereby, that person acts upon it to the loss of his property and to his legal injury,
- A deception, intended to wrongfully obtain money or property from another who acts on the deceptive statements or acts, believing them to be true, and
- Intentional perversion of the truth in order to mislead someone into parting with something of value.

From the point of criminal law, fraud is most often defined as a criminal deception, whereby, the use of false representations results in an unfair advantage or to harm of another’s interest.



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Sir James Fitzjames Stephan, a judge, codifier and historian of the law in the nineteenth century, and one of the earliest to author a textbook on the Criminal Law of England, proffered that there are two essential elements of fraud, including:

- Deceit or intention to deceive, and
- Either actual injury or possible injury, or an intent to expose some person either to actual injury or to risk of possible injury, by means of deceit.

Because of the intent element of fraud, the ability to prove such is a complex undertaking. Fraud must be proven by a higher standard of evidence than other causes of civil action and must generally be proven by clear and convincing evidence. Very often, this higher standard is not easily met. As a result, it has been the authors' experience that very often, allegations of fraud, excepting the most grievous circumstances, are deferred to other causes of action that are more easily-proven with a lower threshold of evidentiary support. In many of those actions, we are requested to provide financial expert assistance.

By way of brief example, in Pennsylvania, a person is liable for fraud if/when he or she makes a fraudulent misstatement of material fact to another person. If that person relies on the fraudulent misrepresentation and suffers injuries, the person making the fraudulent misrepresentation is liable for the those injuries.

In order for the injured party to be successful in establishing that a fraud was committed, it is necessary that he or she prove:

- That the defendant made a misrepresentation to the plaintiff,
- That that representation was fraudulent,
- That the misrepresentation was of a material fact,
- That the defendant intended for the plaintiff to rely on the representation,
- That the plaintiff did rely on the defendant's misrepresentation, and
- That the misrepresentation was a factual cause of the harm suffered by the plaintiff.

Of course, in addition to those items noted above, it is also necessary to quantify and prove the true amount of harm caused by the misrepresentation.

In assessing Pennsylvania Criminal Laws, it is noteworthy that general rules do not exist, and that white collar crimes relating to monetary injuries resulting from fraudulent activities are contained within a statutory framework



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that is specific to the illegal conduct being alleged. By way of example, again, these malfeasances are addressed under state law in computer crimes, credit/debit card fraud (access fraud), embezzlement, identity theft, insurance fraud, money laundering, racketeering, securities fraud, tax evasion, telemarketing fraud, and theft and larceny statutes.

From a federal standpoint, fraud between two private parties, as well as the public at large, can be criminally prosecuted under federal law. Primary jurisdiction often lies with the Commerce Clause, although the Postal and Taxation Powers afforded the federal government are often used as bases for prosecution.

The legal complexities of determining the prosecutorial venues of criminal fraud, and the many various considerations that must be undertaken by government and defense attorneys in making those decisions, are far beyond the expertise of the authors of these materials, and decidedly are the responsibility of the legal representatives. The role of Grossman Yanak & Ford LLP, as forensic and financial experts is most-often directed by those attorneys.

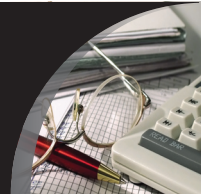
In the end, the determination of fraud is the business of the legal community, and that determination will be advanced based upon the evidence and facts of the case at hand. In advancing positions in a fraud matter, however, attorneys often turn to other experts and specialists in order to properly-determine the often unique and complex facts surrounding the matter. Nowhere is this more-often encountered than in those fraud and theft matters where there are intentionally-deceitful actions that ultimately resulted, or are alleged to have resulted, in an economic loss of some type to the injured party or parties.

Understanding Occupational Fraud and the Workplace

Occupational malfeasance/crime and white collar crime are used almost synonymously in the context of workplace fraud. The phrase “white collar crime” was first coined in 1939 in a speech given by Edwin Sutherland to the American Sociological Society. In that speech, he defined the term as, “crime committed by a person of respectability and high social status in the course of his occupations.”

The debate continues today as to exactly what constitutes white collar crime (one would hardly compare the crimes committed by tarnished securities trader Bernard Madoff with the controller in Pittsburgh who stole monies from the automobile dealer.) However, most do agree that the term broadly includes most nonviolent crimes committed in commercial settings for financial gain to the person(s) committing the act(s).

Many of these occupational thefts/fraudulent acts are accomplished through the implementation of sophisticated means, which are often difficult to detect, by virtue of using a series of transactions designed to cover the trail of the fraudulent party(ies). As noted earlier, most often, these offenses include antitrust violations, computer and Internet



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fraud, credit/debit card fraud, phone and telemarketing fraud, bankruptcy fraud, healthcare fraud, environmental fraud, insurance fraud, mail and wire fraud, government fraud, tax evasion, financial fraud, securities fraud, insider trading, bribery, kickbacks, counterfeiting, public corruption, money laundering, embezzlement, economic espionage and trade secret theft. A somewhat less-discussed type of fraud leading to the success of some of the above-listed activities is “accounting fraud,” which can lend credence to material misstatements of fact necessary to accomplish some of the other fraudulent actions.

The broad description that is most-often applied to these actions, in summary, is simply, “financial frauds and crimes,” both criminal and civil. The injured parties in most of the actions encompassed in the broad definition of financial frauds or crimes in the workplace is, without question, most often the employer. The resultant injuries related to all white collar crimes conducted in the United States is estimated by the FBI to be more than \$300 billion annually. A very substantial portion of that amount is attributable to employer losses, where one or more of its employees has conducted illegal activities in the workplace.

The susceptibility of an organization to becoming a victim of such activities is primarily twofold. Though inter-related, the two reasons for any particular business being a target of these financial frauds and crimes are usually viewed as mutually exclusive.

The first reason that many businesses fall victim to such crimes is a lack of financial internal controls. These controls are, or should be, designed to protect sensitive areas within the businesses’ operational and administrative functions from becoming subject to such abuses. Common sense in nature, the reasons for failing to incorporate such controls in any business prior to falling prey to some financial crime or fraud are many.

Some of the more common explanations for failure to incorporate sufficient internal controls include:

- Lack of understanding of the need for internal controls and lack of knowledge as to how to establish and implement such controls,
- Aversion to the cost of evaluating, designing and implementing a new system of internal controls,
- Misunderstanding of the cost/benefit relationship to the well being of the business on an ongoing basis, and
- Ongoing desire to maintain simplicity in the workplace.

A more-detailed discussion of how financial internal controls are evaluated and how they can be used to circumvent a great deal of the risk of occupational fraud in the workplace will be discussed in Chapter IV of these materials.



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The second reason that many businesses fall victim to such crimes is an overreliance on trust of long-time employees. Repeatedly, the authors have been involved in cases where the perpetrator of the financial malfeasance was a long-time employee. Very often, this employee's daily duties and responsibilities had very little oversight, and, in conjunction with limited or no financial internal controls, the landscape was ripe for an opportunistic individual to take advantage of the situation.

Think in terms, again, of the Pittsburgh automobile dealership and the long-time controller. How is one able to steal more than \$10 million dollars over a six-year period with no one in upper management noticing the missing funds?

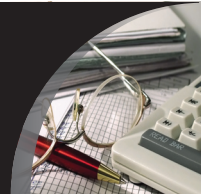
When evaluating potential targets of occupational fraud, then, it should be no surprise that the most-frequently and most-perilously victimized businesses are the smaller ones, where there are fewer financial internal controls, as well as fewer employees. These are also the enterprises where opportunities most-often exist for employees to advance to positions of authority without substantial oversight.

The other element that must not be forgotten is that, while these frauds and the injuries caused thereby are smaller, the fact remains that smaller businesses suffer the largest median losses, per the ACFE report referenced earlier in these materials. All too often, these financial frauds/crimes prove impossible for the business to overcome, and, as a result, lead to business failure.

What can be done to alleviate some of the potential occupational fraud stresses caused by the limited employee base of smaller companies? The key, and most critical, step that can be taken, at no additional cost, is focusing on employee behaviors and trying to understand employee's personal situations. Unfortunately, almost all employees involved in these financial frauds/crimes are "first-time offenders," with relatively strong work histories and without criminal records. This phenomenon, then, makes employee observation and focus even more difficult as it becomes necessary to identify changes in behaviors, as well as employee situations, at any particular time.

The most common indicators of possible employee fraud include the following:

- *Focus should be given to the employee's standard of living* – This is necessarily the case where that standard seems to have changed disproportionately to the financial advances the employee has garnered within the organization. If the employee seems to be living beyond his/her means, there may be reason for pause to ensure that this person is not misdirecting funds from the organization to his/her personal account. Oftentimes, clues are directly in front of management/ownership. If that employee is traveling more, or if the trips are more exotic, there may be some reasons for concern and assessment. Looking to personal property held and acquired (cars, jewelry, real estate, etc.) can be insightful in attempting to identify possible employee fraud/theft.



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- *Focus should be given to an employee's sudden need for cash* – In the most-recent economic recession and in the last decade, it is not unusual to find individuals struggling for any number of reasons. Sudden negative changes in employees' personal situations, as well as expected future expenses, can be good indicators of potential problems in detecting employee fraud. For example, understanding that an employee's spouse has lost his/her job; that a child has become seriously ill; or that there has been a loss of healthcare benefits can be extremely helpful in identifying possible sources of employee fraud.

Additionally, knowing that an employee has children entering college or planning a wedding in the near future can be helpful in understanding the employee's economic stresses and allow employers to assess behaviors that could lead to employee fraud.

- *Focus should be given to the employee's work habits* – Observing employee work habits can help employers detect a potential risk of occupational fraud. If the employer should find that the employee never goes on vacation and works late regularly, the extra effort may not be wholly-related to an incredible work ethic and a strong commitment to the company. It may be that the scope of the deception is such that the scheme requires his/her constant attention and manipulation and his/her presence is necessary to avoid detection. Mandatory breaks from work, such as vacations, can often lead to detection in these circumstances, due to the "ongoing" nature of some complex kiting and lapping transactions.
- *Focus should be given to the employee's attitudes* – Monitoring employee attitudes towards the company or organization can be helpful in certain circumstances where previously-contented employees suddenly become irate and openly-disgruntled towards the employer. Sometimes the shift in attitude can be attributable to the employee being passed over for a raise or promotion. In such cases, it is not unreasonable to assume that the employee may wish to gain retribution for those employer actions that he/she perceives to be wrongful.
- *Focus on employee's responses to inquiries* – It can be particularly insightful to carefully scrutinize employee responses to management's inquiries to identify potential problem areas. Employees who are very excitable and/or overreact to questions are potentially trying to stay off course from the truth. Likewise, when employee responses seem irrational and unreasonable, there should be cause for concern and follow up.
- *Focus should be given to employee's relationships with customers and/or vendors* – Strong customer and vendor relationships are critical to the well being and success of any business. However, when such relationships are "too close," the door to opportunity is opened for any number of fraudulent and abusive transaction, wherein the assets of the company or organization can be absconded. It is imperative that management be aware of the breadth, and depth, of any "noticeable" relationships, and that financial internal controls be implemented to ensure that the relationships do not lead to improper transactions.

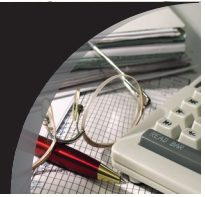


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- *Focus should be given to excessive employee control* – It is important for employers to understand that granting employees broad powers of control over a wide range of operational, administrative and financial matters is fraught with risk of occupational fraud. This knowledge can be helpful in designing limiting internal controls focused on “reigning in” some of the autonomy of that employee’s position. While limited personnel counts may preclude perfect internal control systems as a reasonable option, some greater levels of controls can often serve to mitigate the risks.

Clearly, and as one would suspect, the presence of any one or more of these behavioral attributes does not equate to an ongoing occupational or financial fraud/crime. However, it is not difficult to understand how each of these items could serve as an indicator of potential financial crimes or theft against the company. There are numerous cases where each of these behaviors are easily identified after the fact and, sadly, missed during the course of the occupational fraud.

It is clear from the cases in which the authors have been involved as experts, that, to some degree, all were committed by employees exhibiting one or more of the above-noted behaviors. Moreover, it is not unusual in those cases where we have been involved, that prosecutors often fashion their initial investigatory procedures, discovery and analysis to identify those within the organization exhibiting those behaviors. These identified behaviors are then included as an important part of the prosecutor’s case against the alleged perpetrators.



Fraud & Forensic Accounting

Chapter II – *Understanding Fraud Techniques and Schemes*

As noted earlier in these materials, the term fraud can encompass a wide variety of financial malfeasance and schemes. The specificity of the harmful activities and the methodologies by which the perpetrators attempt to cover their trails can lead to an endless number of methods and nuances by which that activity can be hidden from plain sight. Most treatises and articles on fraud, however, use three common categories to establish a broad framework of similar activities. Embraced by the Association of Certified Fraud Examiners, the three categories are listed below and illustrated in detail in the graph on the following page.

- ***Financial Statement Fraud*** – As the name implies, financial statement fraud devices to commit fraud begin and end with purposeful manipulation and misreporting of the financial results of the organization. The general purpose of such manipulations and misstatements are generally twofold.

First, the intent is generally to lead the financial statement readers and users to reach a conclusion from those statements that conveys an inaccurate assessment and interpretation of the financial performance of the organization. The second aspect is integral to the first, in that, oftentimes, financial statement manipulations and misstatements reflect positive actions by the perpetrator to hide improprieties from the reader or user.

- ***Asset Misappropriation*** – Overwhelmingly the most common of the three broad categories of fraud, asset misappropriation encompasses the theft and misdirection of an organization's assets. In almost every case of asset misappropriation, the stolen assets/property are intended to directly benefit the perpetrator.

Many "large loss" asset thefts start with smaller amounts being taken from the business or organization. As employee/perpetrators gain confidence that the assets have been garnered without notice, brazen behaviors often take over and serve to increase the amount of assets stolen. It is not unusual to observe cumulative losses from asset misappropriations growing exponentially as perpetrating employees gain confidence.

Many business owners and organizations view asset misappropriation as a cash issue. To be sure, cash is the asset of choice for occupational theft. However, inventory, scrap, fixed assets and supplies all lend themselves to potential exposure to asset theft and misuse fraud.

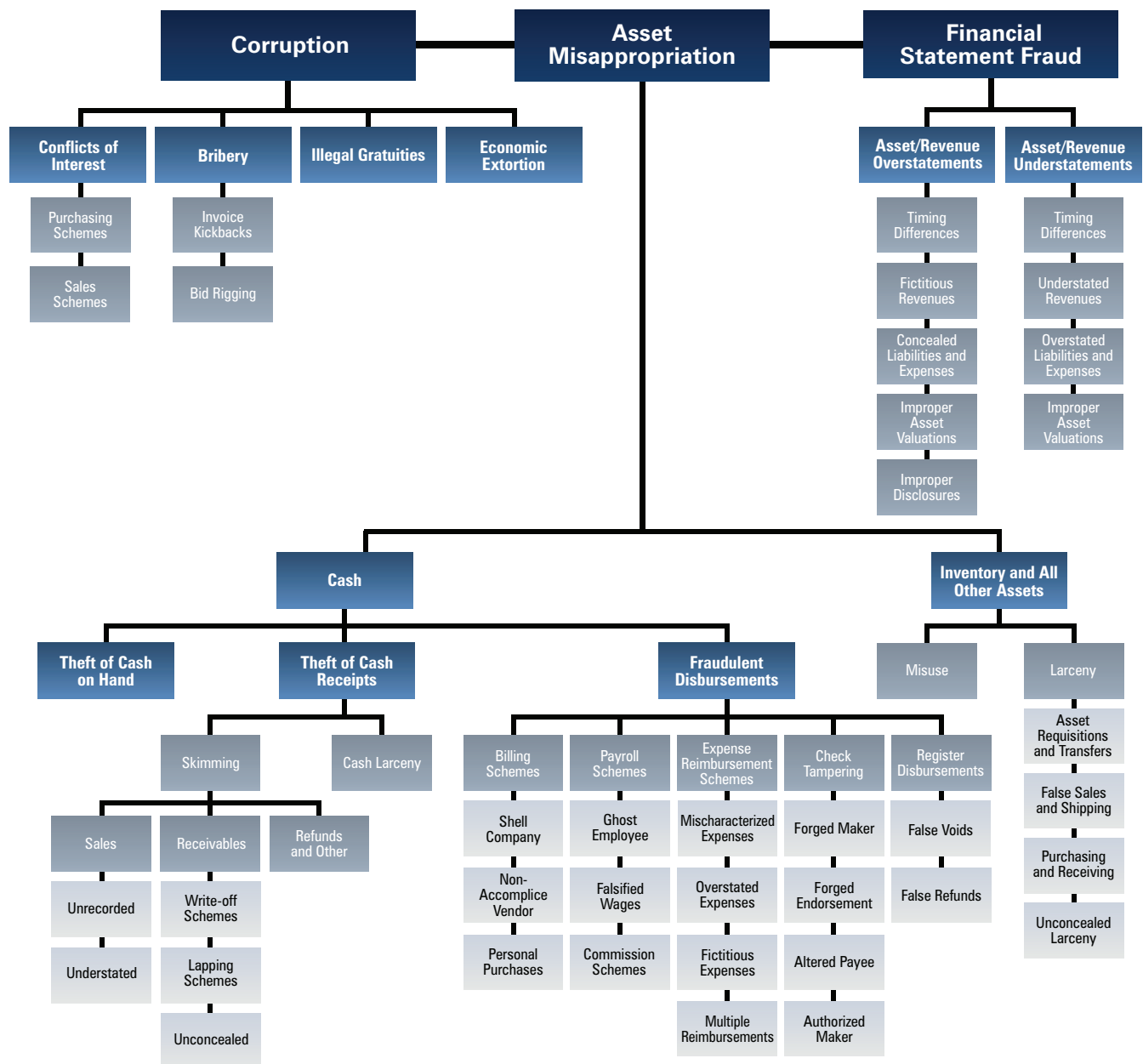
- ***Corruption*** – The ACFE defines corruption as "a scheme in which those committing the fraud wrongfully use their influence in a business transaction in order to procure some inappropriate benefit for themselves or another party, contrary to their duty to their employer or the rights of another."

Common forms of corruption include bribery, inappropriate manipulation of contract compliance, or substitution of inferior or lesser goods than negotiated and agreed. Corruption is also generally held to encompass kickbacks and shell company transactions.

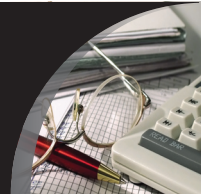


Fraud & Forensic Accounting

Occupational Fraud and Abuse Classification System



Source: ACFE 2012 Report to the Nations on Occupational Fraud and Abuse



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Also reported in the ACFE 2012 Report to the Nations on Occupational Fraud and Abuse:

- Of the three basic types of fraud, asset misappropriation is the most common, occurring in nearly 90% of all fraud schemes. This makes logical sense since many of these frauds occur in smaller businesses, which are less-likely to have appropriate controls and segregation of duties. Even though it is the most common, the fact that asset misappropriation occurs most often in smaller entities leads to a smaller median loss of \$120,000 per occurrence.
- Corruption, including bribery and kickbacks, is the second-most-common form of fraud, being present in almost one-third of all fraud cases that are uncovered. The stakes are generally higher in the game of corruption, leading to the median loss per scheme of \$250,000.
- Finally, the third type of fraud, financial statement fraud, occurs in less than 8% of all cases. However, given the reach of financial statements in the business marketplace, the ability to garner large illegal benefits from financial statement fraud is ever-present. This fraud results in a median loss of \$1,000,000 per occurrence.

Financial Statement Fraud

Financial statement fraud is the deliberate misrepresentation of financial information via intentional misstatements or omissions (amounts or disclosures.) While the least-common of the three major categories of fraud, financial statement fraud accounts for the highest median loss (reaching an astounding high of \$4,100,000 per occurrence in 2010.)

Financial statement fraud is generally perpetrated in order to improve and/or smooth financial results, such as income, earnings per share or earnings before interest taxes depreciation and amortization (EBITDA), and is commonly committed by misstating assets and revenues and/or liabilities and expenses. Misstatements often artificially improve the results in a weak period, but may also occur in strong periods via creation of reserves/allowances that can be used as “cookie jars” in weaker periods.

Such deliberate misstatements may be achieved by completely fabricating assets or liabilities or by recognizing transactions in the wrong period, but are often effected more subtly, via manipulating various financial estimates. Some common estimates that are subject to judgment, and accordingly, manipulation, include: allowances for doubtful accounts, inventory reserves, depreciable lives/methods, contract accounting and various accruals for items such as warranties, commissions and environmental issues.

In some circumstances, financial statement fraud is used to cover up embezzlement within the organization or may be driven by bonus incentives. Interestingly, such frauds often result in no direct financial benefit to the perpetrators and, instead, are focused on meeting organization goals or maintaining leadership positions.



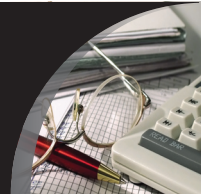
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Some possible motivations for financial statement fraud include:

- **Financing** – Bank agreements frequently include restrictive covenants, such as minimum leverage rate requirements, tangible net worth requirements, minimum EBITDA targets, etc. While these covenants are often non-issues when business is going to plan, they can be powerful motivations for management when times are tougher. Our audit professionals have frequently assessed manipulation of financial covenants as an audit risk during the recent economic recession and have seen companies assessed significant waiver fees or rate adjustments as a result of covenant violations.
- **Meeting ownership expectations** – Meeting the expectations of a demanding ownership team can be a powerful motivator, particularly when one believes that his/her livelihood depends on such.
- **Performance bonuses** – Performance bonuses are common and present very real fraud risks when they are significant. Our audit professionals frequently tailor audit procedures designed to gain assurance that performance bonuses have indeed been met, particularly when they are related to the compensation of management personnel with influence over financial reporting.
- **Attracting additional investment and/or potential sale of the business** – Our merger and acquisition professionals frequently see this motivation when working on the buy-side, particularly in conjunction with working capital adjustments. We often design due diligence procedures around working capital to guard against manipulation of the target and/or the final working capital amount. We also routinely design procedures aimed at assessing EBITDA and/or proposed EBITDA adjustments in EBITDA multiple-based deals.

Chapter V offers more-comprehensive case studies; however, some brief examples of possible financial statement frauds are included below.

- Understating a reserve, allowance or accrual to meet a minimum EBITDA covenant in a bank agreement
- Prematurely recognizing revenue in order to bolster EBITDA in anticipation of an EBITDA multiple-based business transaction
- Overstating a reserve, allowance or accrual in a year that exceeds targets in order to “squirrel away” income to be recognized in future periods
- Overstating reserves in conjunction with purchase accounting in order to meet or exceed investor expectations in future periods
- Recording fictitious sales and receivables in order to meet corporate targets and trigger bonuses
- Capitalizing costs that would be more-appropriately expensed
- Concealing liabilities



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- Failing to disclose contingent liabilities
- Manipulating of margin via sales/cost of goods sold

Ways to implement prevention and detection efforts are discussed in further detail in Chapter IV; however, some specifics important to financial statement fraud include the following:

- Reduce situational pressures
- Reduce opportunity
- Exhibit integrity from the top
- Analyze income statement relationships and fluctuations

While the external audit function should not be relied on to prevent or detect fraud, a consideration in selecting an audit firm should be audit approach. One line of thought that has crept into audit risk assessment over the years has been that a thorough audit of the balance sheet leaves no room for error on the income statement. At Grossman Yanak & Ford LLP, we believe that auditing the income statement is important to audit quality. Further, it helps us to thoroughly understand our clients' businesses and bring value-added insight.

Asset Misappropriation

The process of asset misappropriation can take numerous different roads to the same end – asset theft. The following section is intended to provide participants with a cursory understanding of the more-common schemes encountered in fraud detection and forensic accounting assignments.

Skimming

The ACFE defines skimming as, “the process by which cash is removed from the entity before it enters the accounting system.” In effect, skimming, in its simplest form, is a slang term for taking cash or assets out of the business or organization before they are recorded.

Unfortunately, a second, common definition for skimming in today's electronic economy is “an electronic method of capturing a victim's personal information use by identity thieves.” This second definition, while interesting, is not, in any way related to the subject at hand.

Skimming crimes are varied, but generally involve the theft of revenues, receivables and/or refunds. Reported regularly by the ACFE, revenues are the most popular target for skimming from an employer, with more occurrences



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and total cost than the other two combined. This fact makes perfect sense, as skimming revenue before it enters the accounting records of the employer can be difficult to detect. On the other hand, skimming accounts receivable or absconding with refunds from various sources requires a manipulation of the organization's books and records. Thus, in these events, the fraud is compounded by incorporating some level of financial statement fraud into the abuse.

It should be pointed out that skimming lends itself, by definition, to being most-effective in smaller, cash-basis businesses. For example, it is easy to envision occupational thefts of cash in the restaurant business, the laundromat business or coin-operated car wash business. A less-likely target for this kind of theft would be a metals manufacturer, a construction company or a medical services provider.

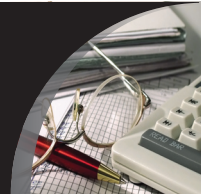
In addition to accessibility to cash in these enterprises, identifying the problem can be difficult, in that no records exist by which the missing pieces of the puzzle might be reassembled. In most cases, the cash has been taken "at the top." As such, auditors, both internal and external, have no records available to cross-check for reliability and defalcations. This lack of a traceable record can lead to a lengthy period of time wherein the fraud continues because of the inability to have the problem identified by virtue of confirming or reconciling accounting issues.

An example of skimming, recently encountered by the authors, involved one of the region's specialty grocery chains. Here, in a high-volume store, a long-time employee was identified as to having taken approximately \$100 a day from the register sales. In fact, items were being rung up at less-than-retail prices and the clerk was collecting the larger amounts. In other cases, the sales were never recorded, but the register drawer was opened and allowed for the thefts.

The problem was identified by an owner with very substantial experience. When confronted, the employee confessed that he/she had been stealing the funds daily for more than four years. The total fraud loss was estimated at \$80,000 - \$100,000.

In another skimming incident, a minister at a local church took approximately \$100 from the church's cash collections prior to deposit each week. The practice was identified in the course of a church audit performed when he was away, and it was later discovered that the skimming activity had taken place for over 10 years. More disturbing, the minister later confessed to often taking larger amounts.

Receivables are less-often the target of skimming, but can provide perpetrators with another viable source of illicit funds. In a nutshell, skimming accounts receivable simply refers to "intercepting" the customer's payment before it is deposited into the bank and credited to the customer's account. Of course, the primary issue with stealing a customer payment is that the customer's "balance due" is not reduced for the amount of the payment that was stolen and, as such, the theft is open to identification in the normal course of business.



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The answer to this problem is usually a manipulation of the organization's books and records to cover the missing payment. How the missing payment is covered is very often dependent upon where that employee works in the company. If the employee is not privy to the organization's books and records, the normal method used to cover the missing payment is "lapping."

Lapping is the practice of covering one customer's payment with that of another customer. In other words, the customer that was "shorted" when the employee stole his/her payment is simply credited with funds advanced by another customer. The problem then becomes one of covering the shorted second customer whose payment was misdirected to the first customer's missing payment. Generally, a payment by a third customer is used to cover the second customer's shortfall, and so it goes.

The maintenance of a lapping scheme is exceedingly difficult and requires a substantial and ongoing effort to continue to cover the missing payments. The complexity of "managing" many misapplications of customer payments in a substantial lapping scheme is almost always going to lead to a collapse and detection. For this reason, skimming accounts receivable with no access to the organization's books and records is not encountered frequently in forensic assignments.

If, however, the organization does not maintain proper financial internal controls and allows the same employee access to its books and records, as well as cash, accounts receivable skimming is more-easily concealed. In this circumstance, all that the perpetrator requires to hide his or her activities is the rudimentary accounting knowledge to credit customer accounts and offset the credit with various debits, most often in expense accounts. Adding to the complexity of identifying this practice is the likelihood of more-intelligent fraudsters to use any number of expense accounts to eliminate ease of detection.

Less common than revenue and receivable skimming are "refund skims." Essentially, refund skims involve the person intercepting amounts due to the company for overpayment to vendors, tax authorities, etc. If the organization has failed to record overpayments due on its books and records, such refunds can easily slip from notice and escape detection permanently. If overpayments due are recorded, the process for cover up is identical to that noted above for covering accounts receivable skimming.

On Book and Off Book Frauds

While accounts receivable and refund skimming are "on book" frauds, revenue skimming is an "off book" fraud. To substantiate "off book" fraud, proof must be developed circumstantially. However, many types of direct and indirect evidence may be available within the books and records to identify "on book" fraud. Examples of such forensic techniques that could indicate skimming is taking place within an organization include: observing industry comparisons of revenue levels; changing gross profit margins; and confirming customer receipts and company books and records.



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Employee Larceny/Theft

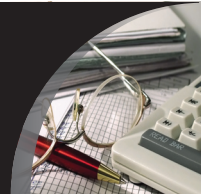
Larceny and theft, in the sense of occupational fraud, simply refers to the misdirection of assets and supplies that are held by the company. Most often, and easiest to understand, is the theft of equipment, inventory, supplies and even cash. In addition, the authors have encountered employees stealing “returned products” scheduled for return to manufacturers, valuable waste and manufacturing by-products (such as metals waste generated via a stamping operation). Retail theft is extremely common, as many of the products sold in a retail establishment can easily be used by employees.

Theft of cash is ordinarily an event that occurs after the receipt has been recorded in the books and records of the company. This asset misappropriation scheme is not at all complex, as it simply refers to stealing physical cash from the cash register, from petty cash or from a customer deposit. Most often, the loss of cash in this fashion is identified through cash control procedures, including reconciliations that are mechanically out of balance.

Theft of inventory, equipment or supplies can generate a more-significant loss to the organization, in that most businesses and organizations do not collect or hold large amounts of cash. The difficulty in committing theft of these assets is the physical act of removing them from the employer’s place of business undetected. Depending on the size of the asset, concealment methods during the course of removal from the employer facility can vary widely. Additionally, there is often more than a single person involved in these types of fraud/theft, and collusion can work to mitigate even the best of internal control systems.

Concealment of the theft after the fact is dependent on the position of the employee and his or her access to the organization’s books and records. Obviously, the greater his or her access, the easier it will be to conceal the theft. Normal day-to-day business activities can be used to conceal the theft of employer’s physical assets and include the following types of transactions:

- Write-off of the asset through shrinkage,
- Limited or no daily use of the stolen asset in the course of the business,
- Labeling the missing asset as a customer adjustment, no charge transaction, promotional transaction, a transfer or internal consumption use,
- Acceptance of goods without documentation or creating false documentation,
- Creating false work orders,
- Creating false reports as to quantity, quality or specifications (internal consumption assets are susceptible to this concealment strategy),



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- Creating fictitious credits to hide the shortage,
- Non-billing of the asset sale, and
- False inventory counts or alterations to physical count records after completion.

Concealment can take many different routes and is subject only to the creativity of the thief. By way of example, the authors have observed the write-off (expensing) of inventory characterized as scrap with little or no value. Furthermore, we have observed thefts characterized within the organization's books and records as charitable contributions.

Other Asset Misappropriation Schemes

Not all asset misappropriation requires physical theft. Typically, any misuse of a corporate asset can be characterized as asset misappropriation. To that end, numerous organization assets can be misused in any number of ways. Often, that misuse has a direct relationship with the type of asset involved in the scheme. For example, those assets that lend themselves particularly to theft or misuse include: real estate such as apartments, vacation homes and lodging facilities; transportation assets including planes, vehicles and boats; and office equipment, computers and specific application tools.

Examples of various asset misuse schemes include:

- *Acquiring assets not necessary for the business* – In this scheme, there is no legitimate purpose for acquiring the asset. Once acquired, if the asset is used by senior executives, the result may be disguised compensation.
- *Purchasing overpriced assets* – In this scheme, the amount paid for the asset far exceeds its utility and value to the business. Often transacted with a related party, without disclosure, such devices result in drawing out and misdirecting corporate funds.
- *Bargain asset dispositions* – In this scheme, assets are sold, again, to related parties, at bargain prices. Continued use by the related party or sale by that party for fair value results in asset misuse.

Intellectual Asset Thefts and Misuse

The misuse of intellectual assets includes: employee theft; unauthorized disclosure; misuse; infringement; and indiscriminate handling of intangible assets, including technical know how, trademarks, product formulations, and internally developed and purchased software. With the rise of digital technologies and Internet file-sharing networks, the theft and misdirection of intellectual property is a growing problem.

Many cases involving intellectual property include more than a single individual and can develop from outside interests enticing the employee to divert these assets. Such thefts and financial crimes are beyond the scope of these materials, but it is important to understand that a great deal of focus is spent on safeguarding these types of assets.



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Fraudulent Disbursements

Fraudulent disbursements can be a descriptive title for a wide variety of fraud and theft schemes. Some of the schemes commonly encountered by the authors in conjunction with the rendering of forensic services include:

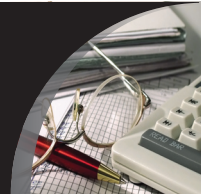
- ***Invoicing and billing schemes*** – Generally, these types of transactions involve the company making payment according to its normal policies, but those payments are being paid on false invoices. The practice can involve senior executives falsifying invoices to cover personal expenditures and personal purchases. In addition, the practice can be extended to setting up false vendors by an employee with access to those records and, thereby, misdirecting payment into bank accounts set up for that false vendor by the perpetrator/employee.
- ***Check tampering*** – This scheme includes direct modification, alteration or forgery of the organization's checks to misdirect the assets. Note that the misdirection will result in some vendor not being paid and, as such, account balances will not reconcile. Much like skimming receivables, discussed earlier in these materials, the process of check tampering can become complex, as steps are needed on a continuing basis to ensure concealment.
- ***False expense reports*** – One of the most-common and expensive employee thefts, inflating expense reports by overstating expenses or creating expenses, is a daily challenge for organizations. Additionally, it is not uncommon to identify personal expenses being added to employees' expense accounts.
- ***Ghost employees*** – This is a payroll scheme wherein payments of corporate funds are made to an employee who does not exist. Operating much like the invoicing and billing schemes noted above, the creation of a ghost employee requires proper documentation (though factually-false) to induce the organization's payroll group to remit funds to the fake employee.

Check Kiting

Check kiting is a form of check fraud, taking into account the advantage of the "float" that occurs in checking account transfers. Check kiting allows the perpetrator to make use of "non-existent" funds in a checking or other banking account. By way of kiting, the check moves from being a negotiable instrument to a de facto form of credit.

Mechanically, check kiting most often works as follows. The perpetrator drafts a check for an amount in excess of the account balance in the bank on which the check is drawn. He or she then writes a second check from a different bank, also with insufficient funds to cover that check. The second check, then, is used to cover the gap or non-existent funds in the first bank's account.

The purpose of check kiting is not really asset misappropriation, but, rather, a play on bank float, that amount of time necessary for the funds to transfer between banks. The practice of check kiting is to falsely inflate the balance of a checking account in order to ensure that the bank that holds the accounts honor those checks that were written against it. If the account is not replenished, the fraud is known as "paper hanging."



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The most-serious, and often the most-detrimental type of kiting, is described as circular kiting. This is a complex form of kiting in which one or more additional banks serve as the location of the float, and involves the use of multiple accounts at multiple banks and financial institutions.

In its simplest form, the kiter, who has two or more accounts of his own at different banks, writes a check on day one to himself from Bank A to Bank B. This check is known as the kite. Because of the transfer, the funds become available at Bank B on that day, and are sufficient to allow Bank B to honor all checks that have been written on that account. On day two, the kiter writes a check on his Bank B account to himself and deposits it into his account at Bank A to provide artificial funds allowing the check he wrote on day one to clear. The cycle continues until the offender is caught or there is a genuine deposit eliminating the need to kite.

Complex kiting schemes can be quite lucrative for some period of time but, ultimately, most of these schemes fall under the weight of the constant focus and attention that is required to monitor them and maintain concealment.

In Summary

The above discussion of asset misappropriation fraud is intended to provide participants in this program with a foundational understanding of some of the more-common devices utilized by offending employees. The creativity of those offenders, as well as specific circumstances surrounding each particular organization or business, can lead to many variations and extensions of these general schemes.

Corruption

Corruption schemes can range from simple to complex and are a growing problem. Corruption is generally associated with bribery, which can be defined as the giving or receiving anything of value to influence an official act. Commercial bribery, which falls under the occupational fraud umbrella, influences a business decision, without the employer's knowledge and consent. Commercial bribery may or may not be a criminal act.

Frequently, corruption/bribery schemes involve collusion between employees and vendors. These transactions generally consist of inflated or false invoices sent by the vendor to a company, with certain kickbacks subsequently paid by the vendor to the company's employee(s). Corruption also includes over-billing schemes, whereby an employee doctors an invoice in order to receive and pocket excess money from a customer. Corruption can occur outside of the organization, as well. For example, inspectors will sometimes approve inventory that is not up to standard for sale and receive kickbacks from the excess revenue generated.



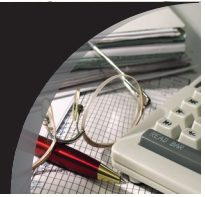
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Prevention and detection of corruption/bribery can be difficult, as it occurs outside of the accounting records. Prevention and detection require strong internal controls, and even more so than other schemes, a thorough understanding of the business and industry. Because of the collusion involved, and fraudulent records that may be produced on behalf of the vendor (who may or may not have good internal controls), internal controls at any particular organization may not be sufficient to prevent and detect corruption/bribery. Perhaps the most powerful deterrent to corruption/bribery is a knowledgeable and active owner. However, requiring competitive quotes and having multiple people participating in the purchasing function can also be effective in preventing fraud.

Concluding Thoughts

Given the very broad range of possible frauds, it is difficult to set forth in these materials an exhaustive listing of every possible form of financial malfeasance. However, understanding the three fundamental categories of fraud, as well as the specific types of financial fraud included in those categories, can go along way in helping legal practitioners become sufficiently proficient to better represent their clients and to effectively communicate and work with forensic specialists.

It is not the responsibility of the legal profession to identify and quantify the occurrences of occupational fraud in the workplace. However, a thorough understanding of the dynamics of such crimes may lead to earlier detection and to the savings of substantial organization resources.



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Chapter III – *Forensic Accounting and Fraud Engagements*

In today's business climate disputes are prevalent, whether due to misunderstandings, mistakes or deliberate misrepresentations. For better or for worse, many of these disputes are settled via our legal system, or merely with threats of taking the case to court. Our Firm has the skills and experience to help you and your client in these contentious situations. This chapter will define forensic accounting and fraud examination; will distinguish such from audit services; will provide an overview of forensic and fraud services; and will discuss important factors in engaging a CPA for such services.

Definitions

- ***Forensic*** – belonging to, used in, or suitable to courts of judicature or to public discussion and debate (Merriam Webster)
- ***Accountant*** – a person concerned with the maintenance and audit of business accounts and in the preparation of consultant reports in tax and finance (Collins Dictionary)
- ***Forensic Accounting*** – the use of professional accounting skills in matters involving potential or actual civil or criminal litigation, including, but not limited to, generally acceptable accounting and audit principles; the determination of lost profits, income, assets, or damages; evaluation of internal controls; fraud; and any other matter involving accounting expertise in the legal system (ACFE)
- ***Fraud*** – intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right, an act of deceiving or misrepresenting (Merriam Webster)
- ***Fraud Examination*** – a methodology for resolving fraud allegations from inception to disposition. More specifically, fraud examination involves obtaining evidence and taking statements, writing reports, testifying to findings, and assisting in the detection and prevention of fraud (ACFE)
 - Most fraud examinations involve forensic accounting, but not all forensic accounting is fraud examination

Distinct Difference in Approach of Forensic versus Audit Engagement

An *auditor's responsibility* is to express an opinion on financial statements based on an audit. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.



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A *forensic accountant's scope* tends to be more-specific and focused; procedures are generally more exhaustive; the goal is often to defend and/or refute in an advocacy arena rather than to express an opinion. A forensic accountant uses a very different approach in coming to a conclusion than a traditional auditor. Forensic accountants look to analyze data, form a hypothesis, test the hypothesis, and refine and amend the hypothesis according to results.

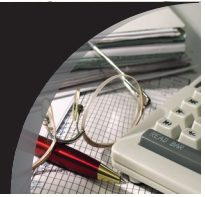
AUDIT VS. FORENSIC ENGAGEMENTS

Item	Audit	Forensic Engagements
Frequency	Recurring Audits are performed on a regular and recurring basis.	Non-Recurring Forensic engagements are not recurring. They are only conducted when deemed necessary.
Scope	Financial Statements An audit's scope is limited to the client's financial statements.	Specific Identified Issues A forensic engagement's scope tends to be more specific and focused, while utilizing exhaustive procedures.
Objective	Opinion An auditor's responsibility is to express an opinion on financial statements based on an audit.	Identify, Clarify, Prove, Quantify The goal of forensic engagements tends to be to defend or refute an advocacy arena rather than to express an opinion.
Environment	Routine The audit process is completed in a very routine nature.	Non-routine/Adversarial Forensic engagements goal is to affix blame which makes them adversarial in nature.
Approach	Support Opinion Audits include examining evidence, on a test basis, supporting the amounts and disclosures in the financial statements.	Resolve Issue Forensic engagements analyze data, formulate a hypothesis, test their hypothesis, and refine and amend their hypothesis in order to affix blame.

Auditor's Responsibility

The ACFE 2012 *Report to the Nations on Occupational Fraud and Abuse* demonstrates that only 3% of frauds were discovered by auditors. It seems relevant, then, to consider an auditor's responsibility relative to fraud.

Auditor's responsibilities are laid out in the professional standards published by the AICPA. These responsibilities are shown in AU §110 – *Responsibilities of the Independent Auditor* and AU §316 – *Consideration of Fraud in a Financial Statement Audit*, detailed on the following pages.



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- **AU §110.01** – The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with generally accepted auditing standards. These standards require him to state whether, in his opinion, the financial statements are presented in conformity with generally accepted accounting principles and to identify those circumstances in which such principles have not been consistently observed in the preparation of the financial statements of the current period in relation to those of the preceding period.
- **AU §110.02** – The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.
- **AU §316.13** – Due professional care requires the auditor to exercise professional skepticism. See section 230, *Due Professional Care in the Performance of Work*, paragraphs .07 through .09. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.
- **AU §316.14** – Prior to or in conjunction with the information-gathering procedures...members of the audit team should discuss the potential for material misstatement due to fraud. [This includes] an exchange of ideas or "brainstorming" among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.



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- AU §316.26 – The auditor's inquiries of management and others within the entity are important because fraud often is uncovered through information received in response to inquiries. One reason for this is that such inquiries may provide individuals with an opportunity to convey information to the auditor that otherwise might not be communicated. Making inquiries of others within the entity, in addition to management, may be useful in providing the auditor with a perspective that is different from that of individuals involved in the financial reporting process. The responses to these other inquiries might serve to corroborate responses received from management, or alternatively, might provide information regarding the possibility of management override of controls – for example, a response from an employee indicating an unusual change in the way transactions have been processed. In addition, the auditor may obtain information from these inquiries regarding how effectively management has communicated standards of ethical behavior to individuals throughout the organization.
- AU §314 – *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* and AU §339 – *Audit Documentations* are also relevant (SAS 109 and 103, respectively).

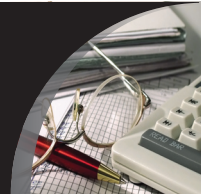
Management's Responsibility

Every audit engagement letter and representation letter is explicit with regards to Company management's responsibility with respect to fraud. A sample of this language is included below.

You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the company involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements. Your responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the entity complies with applicable laws and regulations.

It is important to note that it is the client's responsibility to design and implement controls to prevent and detect fraud. The auditor's objective is to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether by error or by fraud.

See further discussion in Chapter IV regarding preventing and detecting fraud.



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Forensic and Fraud Procedures

When a Certified Public Accountant (CPA) is serving as an auditor, focus is on performing procedures designed to gain reasonable assurance that selected financial statement balances are not materially misstated. Accordingly, the approach is broad, covering all significant financial statement categories. An auditor employs both analytical and detailed procedures in order to accomplish his/her objective.

While performing forensic or fraud services, a CPA may employ analytical procedures in order to identify potential issues; however, once the issues are identified, the detailed work performed tends to be substantially more-comprehensive than in an audit, as the objective is not subject to the concept of materiality, but is routed in proving and/or specifically quantifying amounts. The scope of work and type of procedures performed in such engagements is completely customized for the specific circumstances.

CPAs also utilize evaluations of internal control within the organization. This can be accomplished through review of documented control procedures; interviews with management, staff and employees who directly handle the financial obligations of the organization; and testing of various controls to determine if they are followed, and how effective they are. Controls related to check signing, segregation of duties and transaction approvals are common documented control procedures. Testing internal controls can provide a gateway to vulnerable areas where fraud may be more susceptible.

The primary purpose of a CPA engaged for forensic or fraud services is to gather evidence. Evidence can be obtained and maintained in various forms, which include documentary, client testimonial, observational and any other physical evidence. The fraud examiner will use this evidence in constructing a case to support or refute a specific claim.

Selecting an Accountant for Forensic and/or Fraud Services

There are many important considerations to be made when selecting a CPA for forensic or fraud services. First, their purpose must be determined. The organization needs to consider the specific need, whether it is for an expert witness, counsel, or is preventative in nature.

An expert witness is someone who has exemplary character, coupled with specialized knowledge and a prolific skill set. He/she is someone that can be counted on to make a case, as well as be credible to the trier of fact. This examiner must be a reputable witness on the stand, truthful under oath, calm and collected under the pressure of hostile examination, and display an ability to make complex subject matter understandable to the person trying the case. If an organization is searching for a forensic accountant for the purposes of counsel, they will search for someone with the intelligence to locate the truth and create a case on paper.



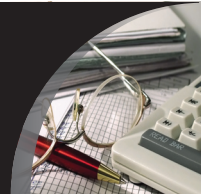
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CPAs can also be used in a preventative role with respect to fraud. CPAs are qualified to assist companies in being proactive and to implement preventative measures which deter fraud from occurring. Often, these engagements will be of a consulting nature and will lead to various control-related recommendations. The ultimate goal is for the CPA to assist the company in attaining enhanced anti-fraud measures, which ultimately lead to fewer opportunities for fraud to occur; more timely detection of any fraud which does occur; and consequently, less monetary loss due to fraud.

In general, CPAs qualified to serve in this capacity are creative, personable and honest. They are able to keep confidences and perform their tasks using sound professional judgment. The nature of these services requires a persistent work ethic in order to ultimately uncover and analyze information that will support or refute specific claims. These experts are expected to apply these characteristics in every aspect of their work to provide a high-quality product and service to those who are engaging them.

Certifications

- **Certified Public Accountant (CPA)** – The requirements, which are set by each state board of accountancy, include: completing a program of study in accounting at a college or university; passing the Uniform CPA Exam; and obtaining a specific amount of professional work experience in public accounting (the required amount and type of experience varies according to licensing jurisdiction.) CPAs provide a wide range of services and are employed in public accounting and other professional services firms, business and industry, government and education. CPAs in public practice are engaged by their clients for a variety of services including accounting, auditing, tax, personal financial planning, technology consulting and business valuation. CPAs employed in business, industry and government are likewise responsible for various activities, including accounting and financial reporting, implementing and managing internal controls and information systems, compliance with tax and other laws and regulations, and other areas of business and financial management.
- **Certified Fraud Examiner (CFE)** – The CFE credential denotes proven expertise in fraud prevention, detection and deterrence. CFEs are trained to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. CFEs around the world help protect the global economy by uncovering fraud and implementing processes to prevent fraud from occurring in the first place.
- **Certified in Financial Forensics (CFF)** – The American Institute of Certified Public Accountants (AICPA) established the Certified in Financial Forensics (CFF) credential in 2008 for CPAs who specialize in forensic accounting. The CFF credential is granted exclusively to CPAs who demonstrate considerable expertise in forensic accounting through their knowledge, skills and experience. The CFF encompasses fundamental and specialized forensic accounting skills that CPA practitioners apply in a variety of service areas, including bankruptcy and insolvency, computer forensic analysis, family law, valuations, fraud prevention, detection, and response, financial statement misrepresentation, and economic damages calculations.



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A Word of Caution

The discovery of fraud often leads to powerful emotions. How one reacts to the discovery is important. While publicly embarrassing or finding a way to exact revenge on the perpetrator may be one's first instinct, the most important action in this situation is discretion. If the suspect is accused of fraudulent action and is actually perpetrating fraud, they are very likely to tamper with evidence or destroy important documentation. In addition, someone could be wrongfully accused of fraud and could possibly bring a lawsuit against the individual accusing them and/or the organization. Employees should never take matters into their own hands. Rather, it is imperative that a strategy be developed by management, working with the organization's accountant, attorney and/or an externally-engaged forensic accountant to ensure that the situation is dealt with appropriately, and that no wrong moves are made.

Concluding Thoughts

Forensic and fraud engagements are completely custom engagements, designed for a specific purpose. Selecting a CPA that you or your client will engage for such services is an important decision. In some high-profile circumstances, only a top-flight, fully-credentialed individual at an international CPA firm will be acceptable. However, in many cases, an intelligent, experienced, persistent and creative CPA may be just as capable and significantly more cost-effective.



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Chapter IV – *Prevention and Detection*

Introduction

Fraud is prevalent in today's business environment. Large and small businesses, alike, are prone to significant losses resulting from fraudulent activities. While our Firm is equipped to serve you and your clients when you come across such issues, for everyone's sake we would much prefer to see the fraud avoided. A few excerpts from the ACFE 2012 *Report to the Nations on Occupational Fraud and Abuse* are noteworthy with respect to prevention and detection:

- The presence of anti-fraud controls is notably correlated with significant decreases in the cost and duration of occupational fraud schemes.
- Largely, because of fewer anti-fraud controls, occupational fraud is a more significant threat to small businesses.
- In 81% of cases, the fraudster displayed one or more behavioral red flags that are often associated with fraudulent conduct.
- Nearly half of victim organizations do not recover any losses that they suffer due to fraud.

Further, the costs of fraud are far more extensive than the dollars stolen and the resultant additional borrowing costs or lost working capital. Fraud tends to have many indirect consequences that cost the Company, both directly and indirectly.

Obviously, a fraud investigation in and of itself can be a costly endeavor, but before the fraud is identified there can be a considerable amount of time incurred by various people in the organization who may be relying on the fraudulent information or struggling to understand trends that do not make sense. After the fraud is identified, there can be considerable harm to an organization's reputation. Finally, organizations may be held liable for criminal acts of employees, when those acts are done in the course and scope of their employment and for the ostensible purpose of benefiting the corporation.

Starting Point

In considering prevention and detection, a good starting point is to simply recognize that fraud happens, and that no business is immune. While we will not delve into such today, sociologists have written at length on Human Behavior and on Crime Causation.

Fraud Triangle

One of the most important concepts that all businesses should understand and utilize, to the end of preventing and detecting fraud, is the Fraud Triangle. The Fraud Triangle concept, originally developed by Donald R. Cressey,



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sets forth the three factors which are present in a situation where fraud occurs: opportunity, motive and rationalization. Opportunity is the situation that enables fraud to occur, such as weak or non-existent internal control. Motive is the reason for committing fraud, such as the need for money. Rationalization is the justification for the fraudster to commit fraud. As motive and rationalization are internal to an individual and cannot largely be externally-controlled, a company must strive to minimize the opportunities available for an individual to perpetrate fraud.

Risk Assessment

Once organizational leadership is willing to think openly about how fraud could be perpetrated within their organizations, it is important to go through a risk assessment process. A risk assessment process essentially consists of evaluating an organization's current situation; determining where fraud could possibly occur; and identifying controls that could or already do mitigate the risk of fraud.

Some examples of deficiencies and risks that can be addressed by companies include: lack of written corporate policies; lack of interest in or compliance with internal controls; unrecorded transactions or missing records; unusual journal entries that lack support; employees living beyond their means; and inconsistent business transactions.

A common framework for internal control and risk management is set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). COSO is a private-sector organization that consists of five professional organizations: The Association of Accountants and Financial Professionals in Business, American Institute of Certified Public Accountants, American Accounting Association, The Institute of Internal Auditors and Financial Executives International.

COSO defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

COSO lists five essential components to its internal control framework: control environment, risk assessment, control activities, information and communication, and monitoring. Like all business models, COSO is limited by human action, which causes errors in judgment by employees and management alike.

The risk assessment process is something that an organization's leadership can work through autonomously. However, in many cases, it may be worthwhile to engage a CPA with internal controls experience in a consulting role.



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Implementing Controls

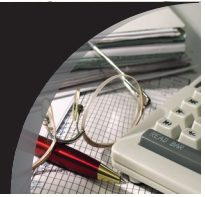
Upon completion of the risk assessment process, an organization should implement internal controls designed to mitigate fraud risks. The organization may also want to formalize a fraud policy. (A sample policy is included as a reference in the exhibits section at the end of these materials)

While appropriate controls will be unique to each organization, some important considerations are as follows:

- Tone at the top of an organization is paramount. Personnel should be trained on internal controls and understand that honesty and accuracy are important to the organization's leadership.
- Controls should be clearly understood by the personnel assigned to perform them, and the personnel need to have sufficient time to perform the controls.
- All personnel should have an avenue for expressing concerns and/or potential issues.
- The quality of both the design and effectiveness of a control environment should be periodically monitored and updated, as needed.
- Custody of an asset should be segregated from recording related transactions, which should be segregated from authorization of a transaction.
- The perception of detection can be powerful and can be accomplished in various ways, including:
 - Management oversight;
 - Internal audit, including an element of surprise;
 - Hotlines that provide employees the opportunity to report known or suspected issues, along with whistleblower protection; and
 - An active audit committee.

Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with laws and regulations. All internal control structures should focus on segregation of duties.

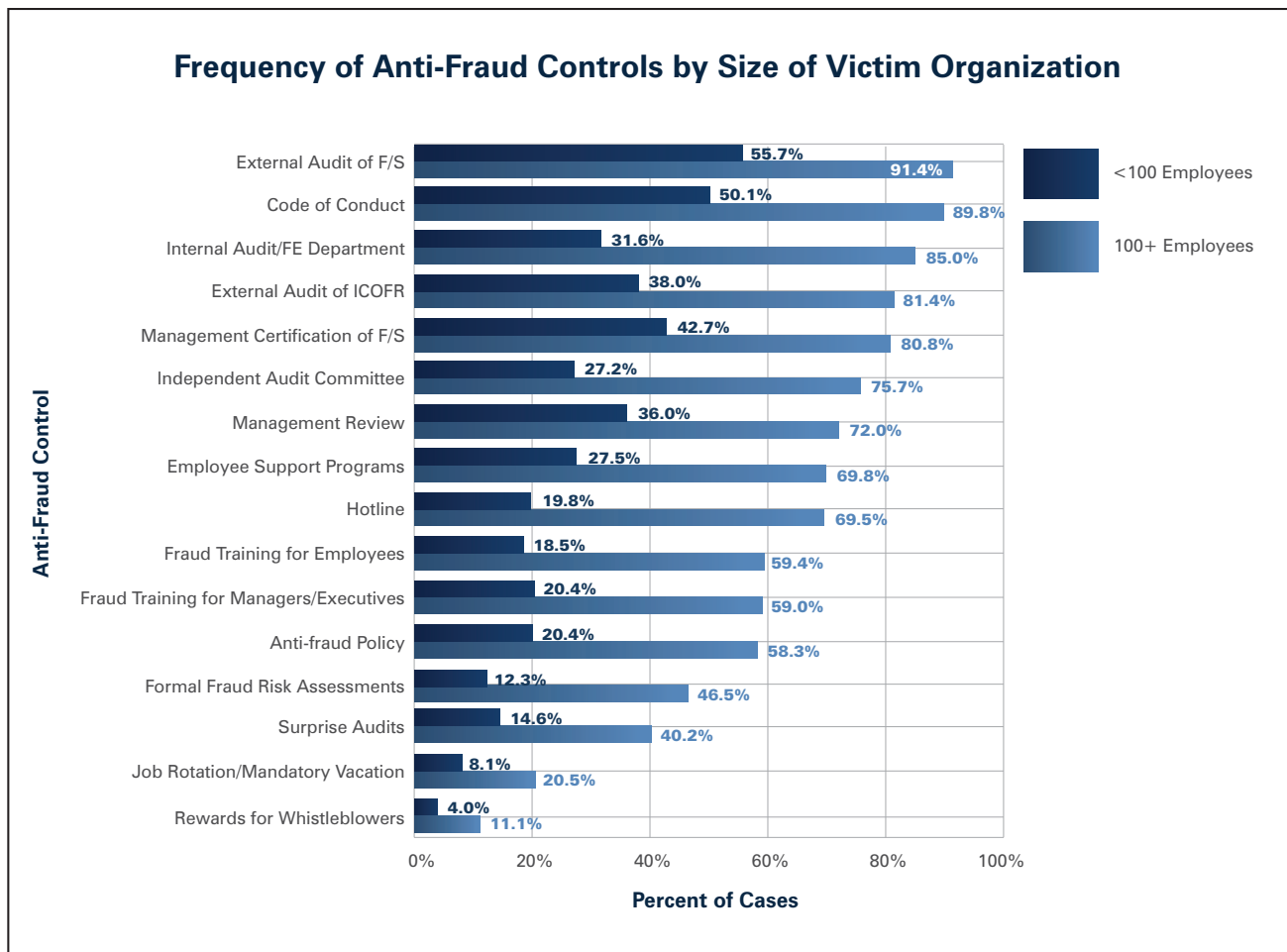
For example, the ordering of raw materials should be separate from receipt/custody of the materials, and receipt/custody should be separate from payment. Such segregation can be evidenced by a "three way match" audit trail. In a three way match, the order is evidenced by a purchase order, which is forwarded to accounting, and the receipt is evidenced by a receiving document, which is forwarded to accounting. The invoice is received by accounting and can be paid after being matched to the respective purchase order and receiving report.



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When segregation of duties is not possible, the entity should be sure to develop mitigating controls. For example, in many small businesses, the same person who records cash activity also reconciles the cash accounts and has access to check stock and/or authorization to transfer funds. In such cases, mitigating procedures may include review of the bank reconciliations, dual signatures on checks over a certain dollar threshold and restrictions, such as dual authorization, on the ability to electronically transfer funds. Another important control, which should be implemented in every organization, is periodic reconciliation of all balance sheet accounts to supporting detail, not just at year end.

The graph below demonstrates the correlation between implemented anti-fraud controls and organization size.



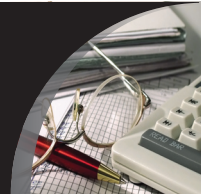
Source: ACFE 2012 Report to the Nations on Occupational Fraud and Abuse



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Not surprisingly, organizations with fewer than 100 employees are dramatically less-likely to have any single control. Sometimes this is a function of an active and knowledgeable owner that substantially mitigates the risk of fraud. Unfortunately, too often the mitigating impact of an active and knowledgeable owner is relied upon too much, or companies make ill-informed cost vs. benefit decisions relative to evaluating and implementing internal controls. In many cases, a CPA firm can help companies improve controls without a lot in the way of incremental costs.

An ACFE-published “Fraud Prevention Checklist” is included in the exhibit section at the end of these materials as a reference. The two-page checklist is brief, but can help to give an idea as to what degree an organization has considered fraud prevention. Please feel free to share some of the statistics we have presented today, as well as this checklist, to help ensure that your clients are actively thinking about fraud prevention.



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Chapter V – *Practical Examples*

This chapter provides a summary of actual cases or circumstances of fraud. The cases vary from one of the most significant cases tried in Western Pennsylvania, to an example of how a perpetrator can start small and amass to a substantial fraudulent scheme. Please note that more detail can be provided relative to cases that are public record.

Le-Nature's, Inc.

The Le-Nature's, Inc. case was the largest case, in terms of dollars defrauded, the Western District of Pennsylvania has seen.¹ A prosecutor called the rise of the beverage company Le-Nature's Inc., "a financial mirage the likes of which I had never even dreamt could have been created." Grossman Yanak & Ford LLP was engaged to provide litigation support services in connection with the case against the wife of Le-Nature's former CEO. As part of our engagement, we gained an understanding of the methods and techniques used in the transactions orchestrated by the Company's former management to misrepresent the financial statements and condition of the Company.

Background

Le-Nature's, Inc. was a privately-held beverage and bottling company originally formed in January 1992. Company management raised capital funds of approximately \$28 million in 2000 and 2002. In August, 2003, a meeting was held with the Company's auditors, where Le-Nature's chief financial officer, chief administrative officer and vice president of administration all voiced concerns about the accuracy of Le-Nature's sales figures. All resigned the next day.

The CFO stated, in his letter of resignation, that the Company's CEO made it impossible for him to discharge his duties to the Company. He said that the CEO maintained almost absolute control over the Company's detailed financial records and denied the CFO access to documentation supporting the Company's general ledger. At that time, the Company's auditors stated that they could NOT be associated with any financial statements until the allegations in the resignation letters were investigated by independent counsel.

In 2003, a special committee of "nonemployee" directors was approved by the Le-Nature's Board of Directors. On August 28, 2003, the committee engaged a law firm to investigate the circumstances that led to the resignations. Additionally, an accounting firm was engaged by Counsel as a financial expert related to the special investigation of certain transactions involving Le-Nature's, Inc.

¹United States v. Gregory J. Podlucky, et al., Cr. No. 09-279, WD Pa.



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In its investigation, Counsel advised that it did NOT discover any misconduct of the CEO and, in fact, issued a report to the special committee on December 8, 2003, that conveyed that it “found no evidence of fraud or malfeasance with respect to any of the transactions reviewed by it. Further, Counsel found no evidence which suggests that the transactions identified by the former employees as being of concern had not been properly reported on Le-Nature’s financial statements.”

A Lender began providing funds to the Company in April, 2003, and continued through the date of the Bankruptcy petition, with the last financing dated September 1, 2006, for \$265 Million. The Lender’s financial due diligence, as well as ongoing monitoring of loan performance, failed to identify any of the fraudulent schemes uncovered by the forensic examination.

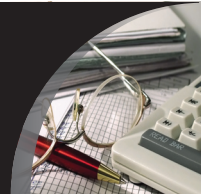
In late 2006, certain minority shareholders of Le-Nature’s were advised by a commercial equipment financing company that a substantial amount of equipment financing proceeds had been diverted pursuant to falsified documents allegedly provided by Company management. Also in late 2006, the Company went into bankruptcy under Chapter 11.

The indictment of the former CEO of Le-Nature’s alleged that he, along with assistance of four other parties (collectively the “Defendants”), devised and intended to devise a scheme and artifice to “defraud and to obtain money and property by means of false and fraudulent pretenses, representations and promises, well knowing that the pretenses, representations and promises would be and were false and fraudulent.” The Defendants participated in a scheme to defraud, in which false accounting and financial information was used on a global scale in a variety of devices or methods, to secure funding for the Company from third parties.

Note that during the historical period examined by the Court and experts appointed thereby, the Company’s financial statements were audited by national certified public accounting firms. The Company was issued unqualified opinions for 2000 through 2005. These opinions, in the accounting profession, are deemed “clean” opinions and the highest graded report available.

Schemes

In order to raise additional funds, Company management significantly inflated sales revenue, accounts receivable, inventory, deposits on equipment and equipment. Company management operated Le-Nature’s in a Ponzi-like manner. The Company was sustained through outside financings, and new financings were used to pay existing obligations. The need for new funding increased each year, and gross operating disbursements alone, exclusive of debt service payments, were more than 2.5 times greater than gross operating receipts over nearly a five-year period.



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Management devised various means by which to receive some or all of the proceeds advances by lessors, despite agreements with them that the funds were to pay a third party for the stated equipment and costs. Management utilized various loans and equipment leases that were obtained with the stated purpose of financing operations and the acquisition of equipment for their current and proposed facilities. The funds were utilized to cover substantial net cash operating losses and the on-going expansion of the Company's headquarters.

The Company debt increased from \$39 million in 2000 to \$382.4 million as of June 30, 2006, an 880% increase. Further, the total future minimum lease payments for the Company's operating lease obligations increased from \$15.5 million in 2000 to \$393.4 million by June 30, 2006, which equates to a 2438% increase over the period. In addition to the aforementioned financing, Company management received diverted equipment financing proceeds in excess of \$125 million over the same period.

Company management had been utilizing two different accounting systems. One was used to track customer sales, accounts receivable and inventory, in connection with the inflated and fictitious transactions used for externally-reporting financial statements. The other was used in limited capacity to track and monitor actual sales, accounts receivable, inventory, accounts payable and payroll. Obviously, neither system could be trusted initially when the forensic engagement was undertaken.

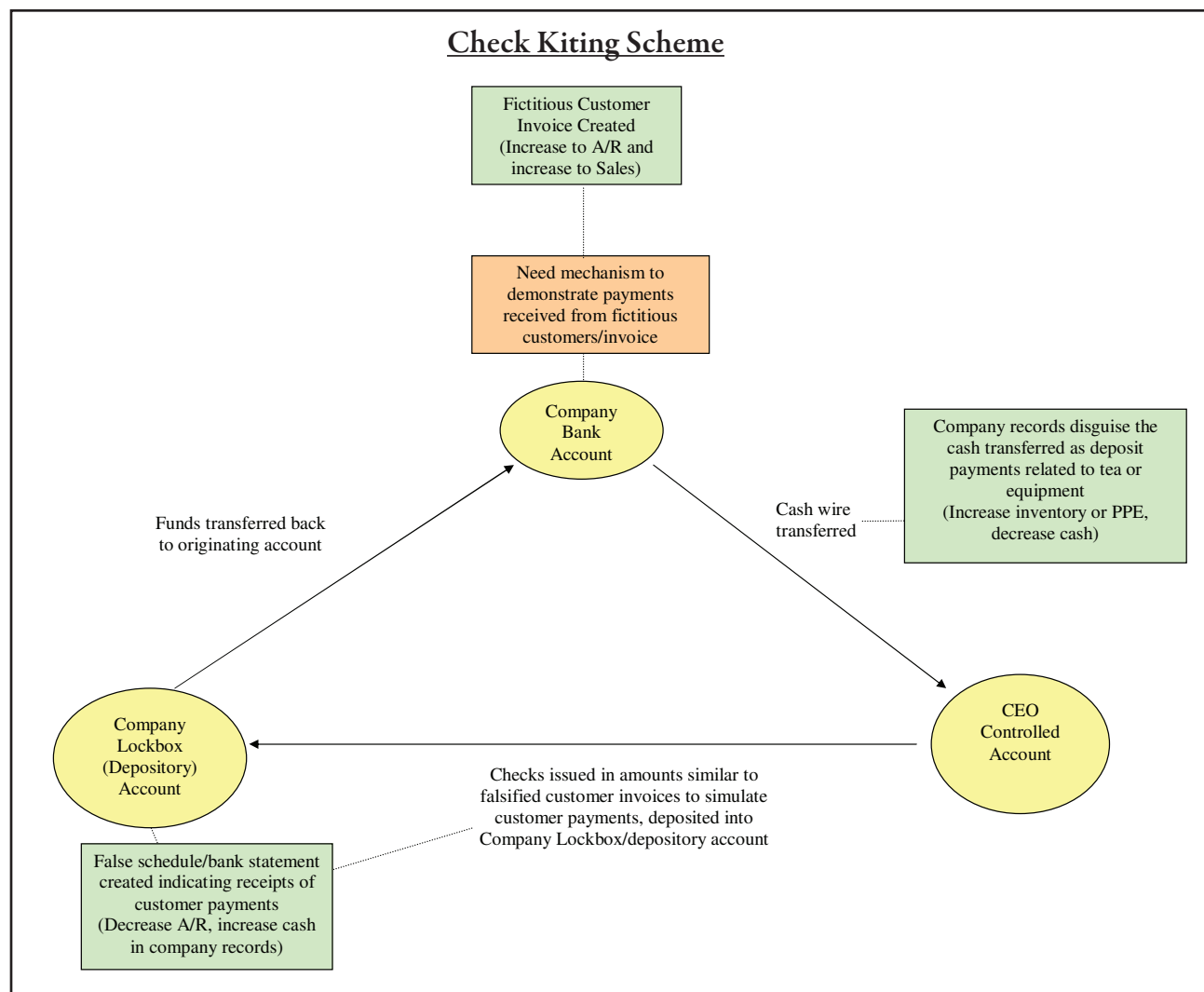
As a result, the forensic accountant conducted an extensive database analysis of the inflows and outflows of cash, utilizing verifiable records and documentation. It was determined, based upon the cash analysis, that the Company spent \$2.78 on operating costs for every \$1.07 it generated through operations.

Prior to July 2002, the massive inflation of sales, accounts receivable, customer receipts, deposits and inventory was largely accomplished using a kiting-like activity between the Company's bank accounts and accounts controlled by the Company's CEO. The mechanics generally occurred as described below.

- Fictitious sales and receivables were created and recorded by Company management;
- Cash was transferred from the Company to an account controlled by the CEO and was disguised in the Company's records as deposits;
- Multiple checks were issued from the CEO-controlled accounts in amounts similar to previously-falsified customer invoices to simulate customer payments;
- Checks were deposited in the Company's lockbox or depository account at the bank;
- Falsified bank documentation was created to evidence the receipt of fictitious customer payments; and
- Funds were transferred back to the originating Company account to replenish the initial transaction.

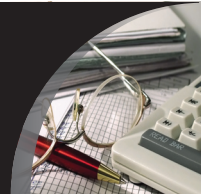


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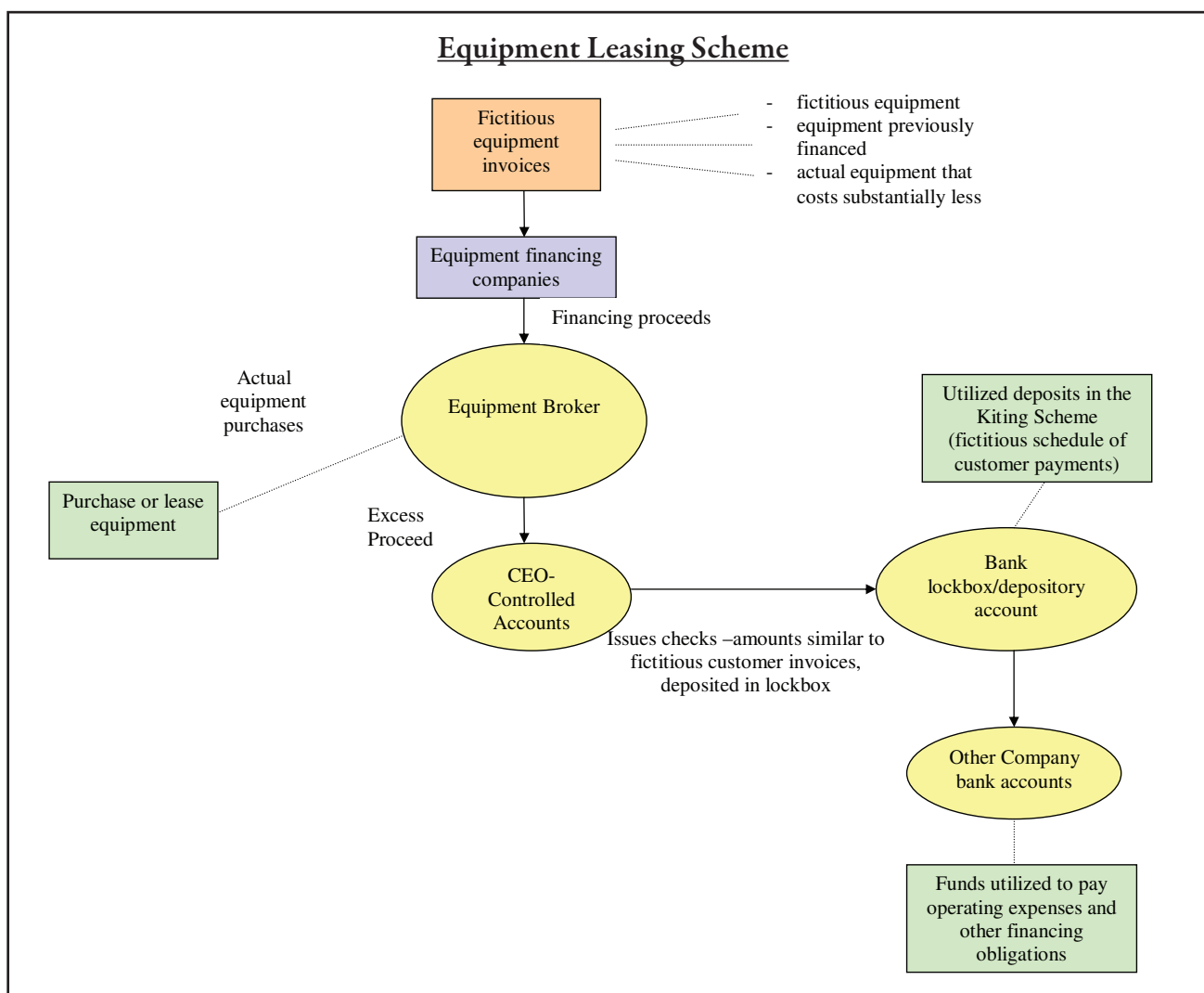
These transactions were used to inflate sales and assets with little or no impact to the Company's net cash balances. One variation included equipment transactions involving an equipment broker. This method worked as follows:

- Fictitious sales and receivables were created and recorded by Company management;
- Funds were advanced by financing companies, pursuant to loan/lease agreements to finance the acquisition of equipment based upon inflated or fictitious invoices submitted as part of the financing;
- Equipment financing proceeds were wired by the financing company to the equipment broker's bank account;
- The equipment broker sent financing proceeds to a CEO-controlled account, totaling amounts similar to previously-falsified customer invoices to simulate customer payments;



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- Checks were deposited in the Company's lockbox or depository account;
- Falsified entries and documentation were created to substantiate receipt of fictitious customer payments; and
- Funds were transferred to other Company accounts and used, in part, to pay operating expenses and financing obligations.



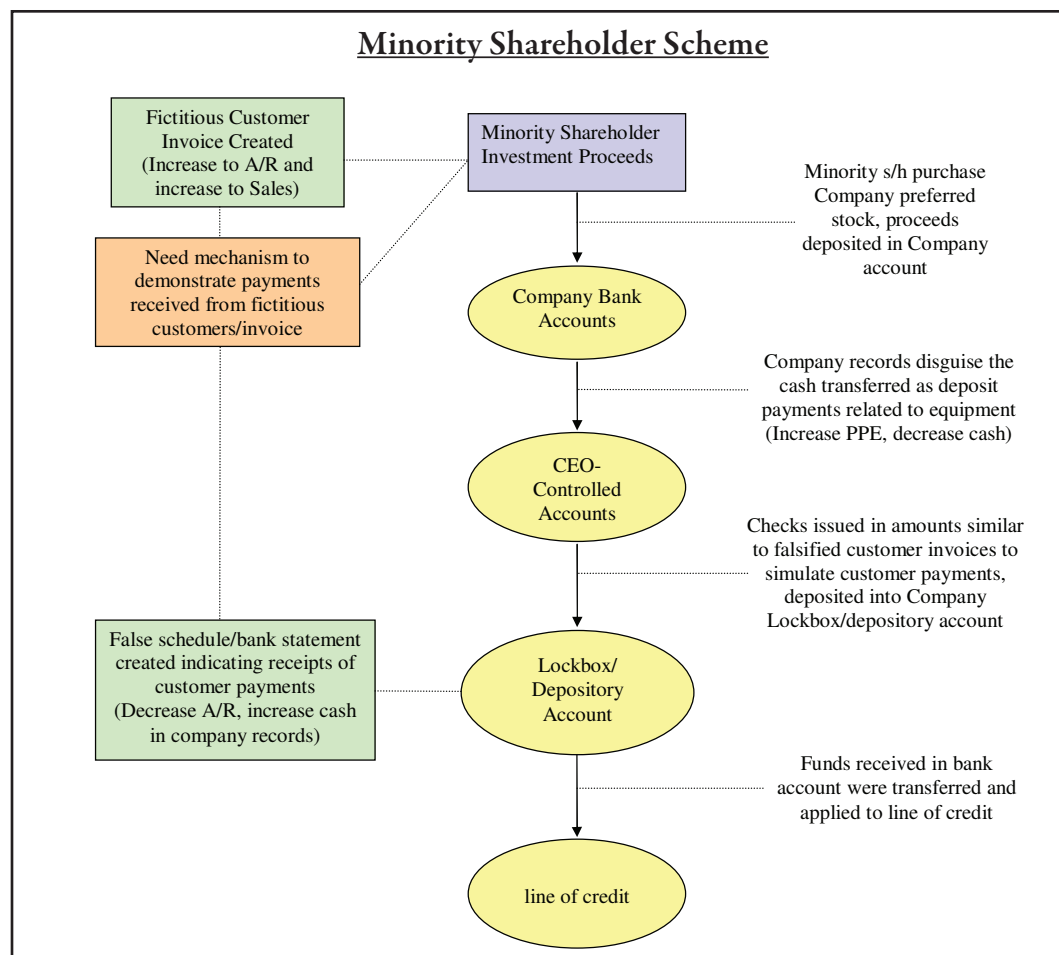
In reality, the Company received funds from the equipment broker, which were treated as customer receipts for purchases of Company products, as opposed to financing proceeds expected by lenders to be used to purchase equipment from third parties.

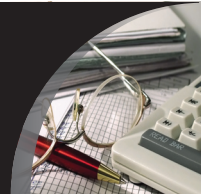


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Another variation included the circulation of funds received from minority shareholders in connection with their equity investments. The mechanics of this method are detailed below.

- Fictitious sales and receivables were created and recorded by Company management;
- Funds received from the minority shareholders were transferred from a Company account to a CEO-controlled account and disguised in the Company's records as deposits on equipment;
- Checks were issued from CEO-controlled accounts, totaling amounts similar to previously-falsified customer invoices to simulate customer payments;
- Checks were deposited in the Company's lockbox or depository account;
- Falsified entries and documentation were created to substantiate receipt of fictitious customer payments; and
- Funds in the same or similar amount received in the bank account were transferred and applied to the Company's line of credit.





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As a result of this variation, sales and assets were inflated, and fictitious customer payments were recorded and applied to fictitious accounts receivable, to provide the illusion of actual customer payments.

After July 2002, Company management ceased transferring actual cash in a circular fashion between the Company and CEO-controlled accounts. Rather, Company management relied on the falsification of bank account statements and related documentation. Fictitious bank statements and underlying documentation were used to inflate hundreds of millions of dollars in sales and assets. This approach enabled management to accomplish the same result, but on a larger scale, with the use of a computer, rather than actually moving cash between accounts. This method began shortly after the kiting scheme ceased and continued through June 2006.

Concluding Thoughts

When all was said and done, loans and capital leases totaled \$385.9 million, and future minimum payments under operating leases totaled \$393.4 million. The CEO engaged in numerous activities and transactions, through which he diverted millions of the Company's funds for purposes unrelated to operations. The forensic engagement uncovered at least \$37.6 million of net funds diverted during the analysis period.

All of the common characteristics that Ponzi schemes typically share existed at Le-Nature's, including:

- Reliance on outside funding;
- Use of new funding to pay old obligations;
- Need for an ever-increasing supply of new funding; and
- Absence of a profitable product, investment or service sufficient to pay promised obligations.

In the end, the Company's bookkeeper provided crucial information to the government. Note that she had never gone to college or studied accounting.

There was an extensive amount of work performed by the U.S. Attorney's expert requiring intimate knowledge regarding the operating, financial and accounting activities of the Company and Company management.

Regional Manufacturer

Fraudsters often start small and grow bolder with each successful fraudulent event. Beginning in 2002, our Firm was engaged to audit a regional manufacturer with annual revenues in excess of \$10M. The business had recently discovered \$1.35M in fraud that had been perpetrated by its long-time, well-respected and trusted CFO over a 10-year period. An investigation determined that the fraud had started with misappropriation of petty cash (\$112,000 over



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10 years) then branched out to personal charges on a company credit card (\$42,000 over five years). The fraud then grew rapidly in depth and breadth as follows: use of company checks for personal expenses (\$57,000); misappropriation of accounts receivable via use of a fictitious collection agency (\$29,000); misappropriation of a cash account designated for employee morale events/efforts (\$202,000); and electronic transfer of funds to personal investment accounts (\$590,000). In addition to the above real cash outflows, the company also incurred \$318,000 of interest and penalties resulting from the fraud.

The owner became suspicious when the business continuously reported income, but became unable to satisfy liabilities in a timely manner. We understand that the CFO was fraudulently overstating inventory in order to show the profits that the owner expected.

While the owner was able to recover a portion of the losses via an insurance claim, the CFO initially moved out of state and suffered minimal consequences. Ultimately, though, he was prosecuted and served jail time. Shortly after the fraud was identified, the Company implemented additional controls, including requiring the owner's signature on all checks and substantially restricting electronic transfers of funds, two relatively simple controls that likely could have prevented much of the fraud.

Baierl Acura

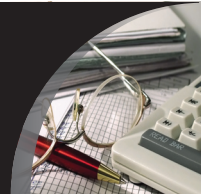
In recent local news, the former controller of the Baierl Acura dealership pleaded guilty in connection with the embezzlement of \$10.2 million from the dealership. The funds were embezzled over a more-than-six-year period.

According to documents filed in federal court, the controller used her position to effect ACH transfers of large amounts of money from Baierl's payroll bank account to one of her personal bank accounts on over 800 occasions between December 2004 and July 2011.

Bank statements were also altered to cover the fraudulent transfers, prosecutors said in court documents. The falsified bank statements were given to outside accountants that were reviewing the dealership's books and records. To offset the losses, she also falsely inflated the general ledger vehicle inventory account balance and added previously-sold vehicles into the dealership's inventory computer database.

According to the U.S. Attorney's Office, "the office will be able to recoup a portion of the financial loss. The amount stated in Court was \$1 million." Thus, the Company will only recover 10% of its losses.

As a result of this fraud, the automotive group is changing its accounting processes. Baierl's CEO said that the company has "instituted new oversight checks and balances in our accounting processes at each of our locations to prevent this from occurring again."



Fraud & Forensic Accounting

Concluding Thoughts

These cases are a few examples of how fraudulent schemes, undetected and ongoing, can grow exponentially. As we have noted herein, fraud encompassing asset misappropriation is most common in smaller businesses, which are less likely to have appropriate controls and segregation of duties.

The Le-Nature's case is an example of how significant financial statement fraud can amass, especially when perpetrators are top management of a Company. Failure to exhibit integrity from the top leads to a lack of traceable record and the inability to identify the problem. There was an incomprehensible amount of effort put forth to maintain the concealment in this case.

As noted throughout this material, creativity of the perpetrators can lead to many variations of the general schemes described herein. Members of the legal community urging their clients to take an active role in fraud detection is the best line of defense.



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Conclusion and Practical Considerations

Understanding occupational financial fraud is critical to helping clients of both law firms and accounting firms to survive subversive employee actions. While the complexity of these illegal actions can often lead to long periods of time where losses accumulate without detection, together our professions can “push” our clients and customers to a higher level of awareness. Hopefully, this greater awareness, then, will lead to more-effective management decisions and the implementation of sufficient financial internal controls to mitigate a great portion of the risk posed by occupational fraud.

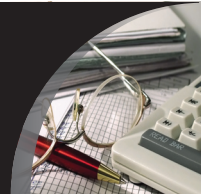
As has been seen, financial internal controls can play a big part in reducing the opportunity for employees to commit fraud. For that reason, it is critical that all companies and organizations periodically undergo a financial internal control “physical.” Such a process allows for experienced professionals specializing in financial and forensic matters to work with management to evaluate the weaknesses in the organization’s financial, administrative and operational functions. Once identified, the appropriate modifications and changes can be made to the entity’s accounting and asset protection procedures to ensure that the risk of such activities is minimized.

In thinking about occupational fraud, such periodic reviews make perfect sense. As noted earlier, the only general accounting service that includes an internal control review is an audit conducted under generally accepted auditing standards. The cost of a financial statement audit can sometimes be cost-inefficient to middle market and smaller businesses. However, the cost of such occasional periodic reviews of internal controls can easily be justified, in that prevention of a single occurrence of occupational fraud can save the equity owners and other stakeholders hundreds of thousands of dollars.

Grossman Yanak & Ford LLP maintains a very high level of expertise in accounting and asset protection control strategies and has broad experience in evaluating financial internal controls for all types of industries.

The other area in which we work regularly in this discipline is in dealing with fraud, or suspected fraud, after it has occurred. We have experience in many assignments where management, Board members, or audit committee members seek our assistance in searching and locating the fraud, if it is indeed present. In cases where it is already verified that the fraud has occurred, Grossman Yanak & Ford LLP can assist with quantifying the fraud and gathering sufficient evidence to assist management and legal counsel in their efforts to move the case forward and remediate the negative effects of the fraud occurrence.

As noted earlier, the cost of a forensic assignment can vary widely, but it can be cost beneficial where the amounts lost to the malfeasance are suspected to be material, and recovery is available through repayment by the perpetrator or via insurance settlements.



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Should you find your client in any of these situations, we respectfully request that you consider Grossman Yanak & Ford LLP as a strong choice for forensic expert services. Much like the damages claims we discussed in an earlier CLE session, we will bring to bear the experienced and knowledgeable financial and forensic expertise required to help you represent your client at the highest possible level of quality.

Should you have questions or an opportunity to use our Firm for these services, please contact us as follows:

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Thank you for today's attendance. We appreciate your support!



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Attorney CLE Series – October 9, 2012



Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory; tax planning and compliance; business valuation; and technology services. Led by five partners, the 22-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities in Pennsylvania, Ohio, West Virginia and New York.

Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receives the services of a skilled professional with a broad range of experience and knowledge that can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a stable practice of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance and Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning a fine reputation in the business community.

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Attachment 1: AICPA "CPA's Handbook of Fraud and Commercial Crime Prevention," An Organizational Code of Conduct

The following is an example of an organizational code of conduct, which includes definitions of what is considered unacceptable, and the consequences of any breaches thereof. The specific content and areas addressed in an entity's code of conduct should be specific to that entity.

Organizational Code of Conduct

The Organization and its employees must, at all times, comply with all applicable laws and regulations. The Organization will not condone the activities of employees who achieve results through violation of the law or unethical business dealings. This includes any payments for illegal acts, indirect contributions, rebates, and bribery. The Organization does not permit any activity that fails to stand the closest possible public scrutiny.

All business conduct should be well above the minimum standards required by law. Accordingly, employees must ensure that their actions cannot be interpreted as being, in any way, in contravention of the laws and regulations governing the Organization's worldwide operations.

Employees uncertain about the application or interpretation of any legal requirements should refer the matter to their superior, who, if necessary, should seek the advice of the legal department.

General Employee Conduct

The Organization expects its employees to conduct themselves in a businesslike manner. Drinking, gambling, fighting, swearing, and similar unprofessional activities are strictly prohibited while on the job.

Employees must not engage in sexual harassment, or conduct themselves in a way that could be construed as such, for example, by using inappropriate language, keeping or posting inappropriate materials in their work area, or accessing inappropriate materials on their computer.

Conflicts of Interest

The Organization expects that employees will perform their duties conscientiously, honestly, and in accordance with the best interests of the Organization. Employees must not use their position or the knowledge gained as a result of their position for private or personal advantage. Regardless of the circumstances, if employees sense that a course of action they have pursued, are presently pursuing, or are contemplating pursuing may involve them in a conflict of interest with their employer, they should immediately communicate all the facts to their superior.

Outside Activities, Employment, and Directorships

All employees share a serious responsibility for the Organization's good public relations, especially at the community level. Their readiness to help with religious, charitable, educational, and civic activities brings credit to the Organization and is encouraged. Employees must, however, avoid acquiring any business interest or participating in any other activity outside the Organization that would, or would appear to:

- Create an excessive demand upon their time and attention, thus depriving the Organization of their best efforts on the job.
- Create a conflict of interest—an obligation, interest, or distraction—that may interfere with the independent exercise of judgment in the Organization's best interest.

Relationships with Clients and Suppliers

Employees should avoid investing in or acquiring a financial interest for their own accounts in any business organization that has a contractual relationship with the Organization, or that provides goods or services, or both to the Organization, if such investment or interest could influence or create the impression of influencing their decisions in the performance of their duties on behalf of the Organization.

Gifts, Entertainment, and Favors

Employees must not accept entertainment, gifts, or personal favors that could, in any way, influence, or appear to influence, business decisions in favor of any person or organization with whom or with which the Organization has, or is likely to have, business dealings. Similarly, employees must not accept any other preferential treatment under these circumstances because their position with the Organization might be inclined to, or be perceived to, place them under obligation.

Kickbacks and Secret Commissions

Regarding the Organization's business activities, employees may not receive payment or compensation of any kind, except as authorized under the Organization's remuneration policies. In particular, the Organization strictly prohibits the acceptance of kickbacks and secret commissions from suppliers or others. Any breach of this rule will result in immediate termination and prosecution to the fullest extent of the law.

Organization Funds and Other Assets

Employees who have access to Organization funds in any form must follow the prescribed procedures for recording, handling, and protecting money as detailed in the Organization's instructional manuals or other explanatory materials, or both. The Organization imposes strict standards to prevent fraud and dishonesty. If employees become aware of any evidence of fraud and dishonesty, they should immediately advise their superior or the Law Department so that the Organization can promptly investigate further.

When an employee's position requires spending Organization funds or incurring any reimbursable personal expenses, that individual must use good judgment on the Organization's behalf to ensure that good value is received for every expenditure.

Organization funds and all other assets of the Organization are for Organization purposes only and not for personal benefit. This includes the personal use of organizational assets, such as computers.

Organization Records and Communications

Accurate and reliable records of many kinds are necessary to meet the Organization's legal and financial obligations and to manage the affairs of the Organization. The Organization's books and records

must reflect in an accurate and timely manner all business transactions. The employees responsible for accounting and recordkeeping must fully disclose and record all assets, liabilities, or both, and must exercise diligence in enforcing these requirements.

Employees must not make or engage in any false record or communication of any kind, whether internal or external, including but not limited to:

- False expense, attendance, production, financial, or similar reports and statements
- False advertising, deceptive marketing practices, or other misleading representations

Dealing With Outside People and Organizations

Employees must take care to separate their personal roles from their Organization positions when communicating on matters not involving Organization business. Employees must not use organization identification, stationery, supplies, and equipment for personal or political matters.

When communicating publicly on matters that involve Organization business, employees must not presume to speak for the Organization on any topic, unless they are certain that the views they express are those of the Organization, and it is the Organization's desire that such views be publicly disseminated.

When dealing with anyone outside the Organization, including public officials, employees must take care not to compromise the integrity or damage the reputation of either the Organization, or any outside individual, business, or government body.

Prompt Communications

In all matters relevant to customers, suppliers, government authorities, the public and others in the Organization, all employees must make every effort to achieve complete, accurate, and timely communications—responding promptly and courteously to all proper requests for information and to all complaints.

Privacy and Confidentiality

When handling financial and personal information about customers or others with whom the Organization has dealings, observe the following principles:

1. Collect, use, and retain only the personal information necessary for the Organization's business. Whenever possible, obtain any relevant information directly from the person concerned. Use only reputable and reliable sources to supplement this information.
2. Retain information only for as long as necessary or as required by law. Protect the physical security of this information.
3. Limit internal access to personal information to those with a legitimate business reason for seeking that information. Use only personal information for the purposes for which it was originally obtained. Obtain the consent of the person concerned before externally disclosing any personal information, unless legal process or contractual obligation provides otherwise.

Fraud Prevention Checklist

The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist is designed to help organizations test the effectiveness of their fraud prevention measures.

1. Is ongoing anti-fraud training provided to all employees of the organization?

- ☐ Do employees understand what constitutes fraud?
- ☐ Have the costs of fraud to the company and everyone in it — including lost profits, adverse publicity, job loss and decreased morale and productivity — been made clear to employees?
- ☐ Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe that they can speak freely?
- ☐ Has a policy of zero-tolerance for fraud been communicated to employees through words and actions?

2. Is an effective fraud reporting mechanism in place?

- ☐ Have employees been taught how to communicate concerns about known or potential wrongdoing?
- ☐ Is there an anonymous reporting channel available to employees, such as a third-party hotline?
- ☐ Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?
- ☐ Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?
- ☐ Do reporting policies and mechanisms extend to vendors, customers and other outside parties?

3. To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?

- ☐ Is possible fraudulent conduct aggressively sought out, rather than dealt with passively?
- ☐ Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?
- ☐ Are surprise fraud audits performed in addition to regularly scheduled audits?
- ☐ Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

4. Is the management climate/tone at the top one of honesty and integrity?

- ☐ Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?
- ☐ Are performance goals realistic?
- ☐ Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and which are used to determine performance-related compensation?
- ☐ Has the organization established, implemented and tested a process for oversight of fraud risks by the board of directors or others charged with governance (e.g., the audit committee)?

- 5. Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?**
- 6. Are strong anti-fraud controls in place and operating effectively, including the following?**
 - ☐ Proper separation of duties
 - ☐ Use of authorizations
 - ☐ Physical safeguards
 - ☐ Job rotations
 - ☐ Mandatory vacations
- 7. Does the internal audit department, if one exists, have adequate resources and authority to operate effectively and without undue influence from senior management?**
- 8. Does the hiring policy include the following (where permitted by law)?**
 - ☐ Past employment verification
 - ☐ Criminal and civil background checks
 - ☐ Credit checks
 - ☐ Drug screening
 - ☐ Education verification
 - ☐ References check
- 9. Are employee support programs in place to assist employees struggling with addictions, mental/emotional health, family or financial problems?**
- 10. Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?**
- 11. Are anonymous surveys conducted to assess employee morale?**