Forensic Accountants Society of North America

FASNA FORUM

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Please be sure to visit us at BOOTH 740 at the PLRB/LIRB Claims Conference, March 22-25 at the Washington State Convention & Trade Center in Seattle, Washington.

Too Hot to Handle

by Michael A. Pivoz, CPA, JD, Mellen, Smith & Pivoz, CPAs, PLC, FASNA Member

The fire started early in the morning, perhaps around 2:00 a.m. Curiously enough, it started in the controller's office, not a part of the business where you would expect to find any flammable materials. What made this starting point more curious, though, was that the fire occurred as a group of investigators, including forensic accountants, were closing in on a financial fraud that, ultimately, the controller was suspected of perpetrating.

So where did we go from here? The first step was to allow the cause and origin experts to do their work. It was quite obvious where the fire started; their mission was to determine how it started. They were able to determine that the fire started in the waste paper basket next to the controller's desk. The ignition source was determined to be a match stick that was located in an area that was still smoldering after the firefighters had put the fire out. There was no physical evidence to determine who had lit that match and left it in the waste paper basket. The facility had no surveillance system, nor did it have a key or card access system that would allow one to identify who had been on the premises at the time the fire was set. Arson was suspected, but could not yet be proven.

Our scope of work increased as a result of the fire. What had started out as work on an employee dishonesty claim had now expanded to include work on a business interruption claim. At no time did anyone suspect that the business owner had any involvement in either the theft of business assets or the arson. Thus, we had to proceed with our evaluation at two levels.

First, under the insurance policies that the business owner had acquired, he was entitled to be reimbursed (up to policy limits) for the losses that he had incurred. Second, the business owner was intent upon filing criminal charges against the party or parties that had caused the losses. Thus, we were asked to investigate for facts that might lead to the perpetrator(s).

The insured filed his proofs of loss relatively quickly. The property loss portion of the claim was finalized first. There were only some minor issues related to the inventory portion, but those were resolved with a few telephone calls. The business interruption claim was the next one finalized. Once an agreement was reached on the restoration period we were able to get an agreement on the methodology under which the lost income would be calculated. Interim payments were made to the insured to reimburse him for his lost income on an ongoing basis. This continued throughout the restoration period.

The last of the claims to be finalized was the employee dishonesty claim. Interestingly enough, this was the claim that started our involvement with this business. Prior to the fire, we had seen records that indicated that significant amounts of cash had been taken from the business. Most of it arose from cash deposits that had never made it to the bank as well as checks that the business received having been negotiated and cashed by a third party, not the business. We had also seen some documentation that indicated that many expenses had been paid for with checks made payable to "cash".

The business had neither a sophisticated accounting/bookkeeping system nor a computer-based system to help run the business. Thus, when the fire struck, most of these records were in the controller's office. From the work that we had performed before the fire as well as the minimal records that survived the fire, we were able to reasonably confirm the amount of the employee dishonesty loss that the business had incurred and were able to finalize the employee dishonesty claim.

Normally, this would have ended our involvement with the loss(es). However, with what we had discovered relative to the employee dishonesty claim prior to the fire and the mysterious nature of the fire, we were asked to spend some time seeing if we could come up with indirect proof as to the perpetrators of the loss.

We were actually successful in finding information that we felt pointed to a perpetrator. It was up to others to verify the information that we discovered and to try to connect it to the suspected party. However, we could not get the connection tight enough to satisfy law enforcement that they could put together a successful prosecution. After more time passed, none of the interested parties felt that further follow-up was justified. The matter was dropped. To this day, no one has been charged with either the theft or the arson. My guess is that no one ever will.

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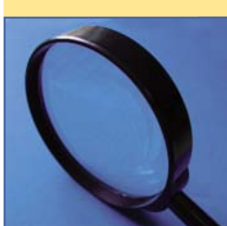

Making the Case for Financial Analysis by Owners of Small Businesses

by Billy Upchurch, CPA/ABV/CFF, CVA, Partner, Baldwin & Associates, PLLC, FASNA Member

Reading the article by Roger Nearmyer in the Winter 2008 FASNA Forum really struck a chord with me. Roger pointed out that as the economy worsens, business owners are likely to start taking a closer look at their expenses in an effort to discover "unnecessary" costs. In some cases, this may lead to uncovering fraud that might not have been discovered otherwise. The point is, business owners should make this an integral part of their routine.

I am amazed at the number of business owners who do not take an active part in actually reviewing and understanding their financial statements. Many of these owners are passive investors in a three or four-owner business. Some of these passive investors, who do not take an active role in running the day-to-day operations of the business, feel like they would be imposing by asking too many questions.

Other passive owners may feel "shut out" by their active partner who runs the administrative and financial part of the business. If this is the case, the alarm in your head should be sounding at full volume. The active business owner should not feel "inconvenienced" to provide his or her partners with some basic financial information. What a shame it would be for a passive owner to discover that he has been hoodwinked by his active partner, simply because the passive owner lacked the resolve or did not want to "rock the boat" by insisting upon a review of the Company's financial statements with all the owners and a knowledgeable member of the Company's accounting staff.

Oftentimes, even owners who are very active in the daily affairs of the business do not devote the necessary time to actually understanding what their financial statements are trying to tell them. Not only does this type of review help detect fraudulent activity, it also helps the owners realize where their business is headed financially. As a result, any changes in operations that are deemed appropriate can be initiated before conditions deteriorate further.

CASEWORK EXPERIENCE

FASNA member casework includes, but is not limited to, cases involving:

- Inventory/property loss
- Employee dishonesty
- Business income loss
- Personal injury or wrongful death claims
- Truth in lending/truth in leasing
- Post judgement matters/ calculations
- Loss of income/earnings
- Divorce and fidelity claims
- Business valuation
- Expert testimony
- Fraud

INDUSTRY EXPERIENCE

FASNA member experience includes, but is not limited to cases involving:

- Auto dealerships and transportation
- Colleges and universities
- Construction, contracting, and engineering
- Financial/money management, trust, and estate
- Healthcare
- State and Indian tribal government
- Insurance claims
- Manufacturing
- Real estate
- Restaurant and hotel industries
- Retailing/wholesale

Reviewing basic financial statements does not have to be a complicated ordeal. Armed with some common-sized historical financial information and some working knowledge of the business, most business owners can quickly review their financial statements for trends and suspicious activity.

Common-size analysis is the process of presenting income and expenses as a percentage of total net sales; assets and liabilities are presented as a percentage of total assets. These percentages could be presented next to the dollar amounts in each account. Most small business accounting packages can present this information on a month-by-month basis with year-end totals in a single report.

Month-by-month information can easily be reviewed to spot increases or decreases of activity in relation to the other months of the current year or prior years. For instance, if your bookkeeper is writing checks to a fake company for operating supplies, this account should appear unusually high when compared to other months or prior year monthly activity (See figure 1.1). Whereas, a comparison of year-to-date activity might not be as obvious unless the dollar amount of the fake invoice was much larger.

Another advantage to a common-sized analysis is the ability to compare your company with other companies in the same industry. Significant differences should be investigated. Although your company may not be comparable to its peer group, you should know the reasons why (local competitive market, local economic differences, etc.)

Best case scenario would be a periodic "State of the Business" meeting whereby a packet of financial information was prepared and sent to the owners of the business one week before the meeting. This should take place at least annually or more frequently if needed.

In addition to the common-sized and historical financial information, other supporting information could be provided for review by the owners, such as bank reconciliations, aged accounts receivable schedule, detailed depreciation schedules, aged accounts payable schedule and other items supporting significant items of assets and liabilities. Year-end payroll reports listing annual payroll for each employee could also be presented and should agree in total with the salaries and wages presented on the income statement. It is always recommended for a company to prepare budgets to see where the Company is headed. If these are available, a budget comparison report could also be presented for review.

Although a company may have an annual external audit of their financial statements performed by a Certified Public Accounting firm, the Company would benefit from an owner review of the financial statements. CPAs use materiality levels to assist them in determining what dollar amount of items to examine. This is necessary in order to keep the cost of the audit down.

However, an account fluctuation considered as an immaterial item in terms of the audit may be something that the owners of the Company would be very interested in. In addition, active owners of the Company have a working knowledge of the company that is inherently more in-depth than the public accounting firm's knowledge of the Company. An unusual account fluctuation that would be very noticeable by an active owner might escape detection by an outside auditor.

In addition, auditors normally perform common-sized analysis on a year-to-date basis. As mentioned above, a month-to-month comparison would be more likely to uncover unusual activity. Owners could present this information to the external auditors as part of the Company's internal control procedures and perhaps negotiate a reduction in the audit fee (Good luck with that!)

An added benefit to this common-sized business review would be the knowledge gained by the owners who may lack financial statement experience. In order to educate the owners, the Company should consider inviting its external accountant to participate in the business review meeting. The external accountant could help the Company's bookkeeper explain things and add credibility to what the bookkeeper has presented. On the flipside, if the bookkeeper tries to sneak something by the owners, the outside accountant could intercede.

When a common-sized business review is conducted along with the advice given by Michael Pivoz in the March/April 2006 FASNA Forum article "Protecting the King," the Company will have gone a long way in making it more difficult for a thief to steal without detection. Pivoz's article described how a company can protect its cash and checking account(s) with proper internal accounting controls,

If the review of this financial information reveals suspicious activity, the Company should consult with its legal counsel who may recommend contacting a forensic accountant for a more in depth analysis. If you have any questions about how to perform a financial analysis of your Company's financial information, please contact one of our FASNA members for assistance.

FIGURE 1.1

	Jan		Feb		Mar		April		May	
	Monthly Amount	% of Net Sales	Monthly Amount	% of Net Sales	Monthly Amount	% of Net Sales	Monthly Amount	% of Net Sales	Monthly Amount	% of Net Sales
Maintenance	200	0.3%	210	0.3%	190	0.3%	205	0.3%	207	0.3%
Office supplies	100	0.1%	120	0.2%	110	0.1%	105	0.1%	120	0.2%
Operating supplies	4,500	6.0%	5,000	6.7%	12,000	16.0%	4,600	6.1%	4,900	6.5%
Postage	252	0.3%	260	0.3%	255	0.3%	261	0.3%	259	0.3%
Repairs	300	0.4%	50	0.1%	200	0.3%	[illegible]	0.3%	260	0.3%

Notice in figure 1.1, the percentage of net sales for the Operating supplies increased from 6.7% to 16.0%. This large fluctuation should alert business owners to question such an increase.

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