

When the Boss Trumps Internal Controls

What a difference a hotline, a routine audit and the right reporting chain could have made.

by Joseph T. Wells

When a college was so broke it couldn't even afford copy paper, toner and other inexpensive supplies, it took some sleuthing to find the reason. This article summarizes the heroic efforts of one CPA, without pay or outside staff (or experience in fraud detection), who helped bring down a powerful and arrogant college president.

Mary-Jo Kranacher, CPA, was an adjunct professor in a large, urban public university. One day after work she was headed out of the building when a colleague, clutching a sealed manila envelope, said in a low voice, "Mary-Jo, I need for you to see this material. But not here, not on campus."

Kranacher took the envelope home and carefully examined its contents. She was shocked to see page after page of purchase orders and vouchers she believed to be clearly inappropriate expenses that had been paid with the college's funds: liquor stores, personal credit card charges and international travel, to name a few. Each and every document had been authorized by the college president, Regina (not her real name).

Regina had been hired three years earlier with great fanfare and support. But the honeymoon was short-lived; she quickly developed a reputation as a ruthless dictator who was fiscally irresponsible. Those who dared to question her authority or decisions found themselves on the street. The personnel director, for instance, was fired while he was at lunch. Upon his return he found the locks on his office had been changed and his personal effects unceremoniously dumped into boxes for him to tote home. And that was just the beginning.

The Freedom of Information Act and the Privacy Act

Two powerful federal laws govern access to government records.

■ **The Freedom of Information Act**, passed in 1966, gives the public access to information held by the federal government, with certain exceptions. Each state has its own laws concerning disclosure of state and local government bodies. There is no specific form for requesting information; it is generally by letter directed to the head of the particular agency.

■ **The Privacy Act** (5 USC, section 552a) concerns your ability to request records maintained about you individually. As with the Freedom of Information Act, there is no specific format for requesting the records. The government may withhold information under certain exceptions, such as national security concerns.

REIGN BY TERROR

I'd personally seen Regina's management style before. At the age of twenty-something, I was appointed a special agent of the Federal Bureau of Investigation. While I was attending the FBI Academy in 1972, J. Edgar Hoover died in his sleep. I learned about it when I went to breakfast the next morning. You couldn't wipe the smiles off the faces of many veteran and rookie agents.

Although Hoover did much good by helping create a legendary law enforcement agency, few would dispute that he reigned by terror. Those employees who displeased him were demoted, transferred or fired. Even U.S. presidents were fearful of Hoover's wrath. He surrounded himself with those who would obey him without question. According to lore, the FBI director was once reading a memorandum when he noticed that the document's margins were too wide. On the memo, he wrote, "Watch the borders." Without asking why, Hoover's underlings immediately dispatched agents to the crossings at Mexico and Canada, too fearful to inquire of him as to what they should be watching.

Much the same atmosphere existed in Regina's reign. Although the college had various boards and committees to provide fiscal oversight, the president ruled with an iron fist; her decisions were not to be questioned by anyone,

any time, under any circumstances. Regardless, Kranacher knew by looking at the documentation that something appeared very, very wrong.

Rumors also had been swirling around the institution that Regina's lavish spending habits added to the deepening financial crisis at the school. Whatever the situation, the CPA was determined to get to the bottom of it, even if it cost her job. By gaining the trust of several employees who worked in the administrative offices of the college, Kranacher was secretly provided with documents that showed the president had used the school's expense account reimbursements to line her own pockets. Kranacher compiled a summary report with copies of the illicit expense account charges that she presented confidentially to the faculty governance and union leadership at the institution. But nothing happened.

DEEP DEBIT

The financial problems of the college had not escaped the notice of one enterprising newspaper reporter. Like many journalists, he hardly considered himself an accounting expert. Through inquiries of others at the college, he finally was led to Mary-Jo Kranacher. He came right to the point: "What is going on here?" Kranacher explained that she didn't have sufficient records to know, for certain, the extent of the problem. The reporter asked, "If I get them, can you help me?" Kranacher agreed to tell him what records she needed to see, and he would request them from the college through the state's open records law, which is modeled after the federal Freedom of Information Act (see sidebar below). Kranacher would review the documents and give him her findings. In return, the reporter agreed to keep her identity confidential. Not Deep Throat, exactly—more like Deep Debit.

Obtaining the college's records proved more difficult than either of them had imagined. They received duplicate boxes of documents in no particular order, and missing records that had to be requested again and again. Finally, after months of painstaking and frustrating work, Kranacher was able to piece together what had occurred.

DISCRETIONARY, SMESHONARY

The president of the college initially was allotted a "discretionary fund" of several thousand dollars to "support the educational, social and cultural events and programs of the college." This fund had little oversight, so Regina used it as a conduit for spending that was highly questionable—if not downright fraudulent. For example, Kranacher found \$84,000 had been

transferred out of the Adult and Continuing Education program and into the discretionary fund. The president also had raided the Auxiliary Enterprises Corporation, a college-related program that raised money from food services, bookstore sales and campus parking. Other targets included the College Foundation, a tax-exempt corporation formed to solicit and administer funds through various fundraising activities, and the College Student Association, which raised money from student clubs and other sources.

Steps to Take

■ ***Do a thorough background check.*** Such a vetting before Regina was hired probably would have revealed her true stripes. Some assume a person vying for a CEO position requires nothing more than a perfunctory screening. That's not only incorrect, the truth is quite the opposite; the more important the position, the more thorough the screening should be. Regina didn't get to be a tyrant overnight—no doubt she had much previous practice.

■ ***Scrutinize the expense accounts of executives.*** Some CPAs incorrectly believe there is a difference between the honesty level of executives and the rank-and-file; there isn't. Indeed, according to the Association of Certified Fraud Examiners' (ACFE) *2004 Report to the Nation on Occupational Fraud and Abuse*, executives were the worst offenders in expense account fraud and abuse.

■ ***Conduct a routine audit.*** Regular audits by independent CPAs go a long way toward preventing (but not necessarily detecting) fraud at all levels. The thought of other eyes examining the finances has been shown to be a powerful deterrent; the ACFE 2004 report documents that fraud losses are cut in half when an organization is audited.

■ ***Ensure the board of directors does its job.*** Providing oversight is the board's responsibility and it must do it right. CEOs cannot be permitted to operate without checks and balances on their authority. As Lord Acton so succinctly put it, "Power corrupts and absolute power corrupts absolutely."

WHILE ROME BURNED

Even though the college was already in deep financial trouble, Regina went on a spending frenzy. There was the nearly \$300,000 spent to renovate the residence that the college provided to her without charge, plus about \$70,000 to refurbish her office. And almost \$25,000 went for her coronation ball as president, paid through the discretionary fund which was subsequently

relabeled the inauguration fund. Kranacher discovered that Regina had taken an “official trip” to South Africa that included her husband and son, all on the college’s nickel. And she blew nearly \$6,000 on upgrades to her taxpayer-provided automobile. She even bought 400 copies of a book that she had edited.

FRAUD OR FOLLY?

Although Kranacher had informed university officials of the problems at the college, it wasn’t until Regina’s wild spending hit the newspapers that a formal outside audit was conducted. The auditors ultimately concluded there was insufficient evidence—because of the wide latitude given the college president—to prove fraud. Instead, Regina was instructed by university officials to repay about \$12,000 of the college’s money, and was asked to step down from her position as college president.

This was Kranacher’s first case of misappropriation, but it certainly wasn’t her last. She went on to earn her certified fraud examiner designation and is now the head of the Association of Certified Fraud Examiners’ Higher Education Committee, which is responsible for providing free support for antifraud education to colleges and universities. She said that she has learned a lot from this case and the ones that followed.

“The situation with Regina is a classic illustration of how management override can defeat the internal control systems that are run by human beings who are often beholden to management for their jobs,” Kranacher observed. “Because this college president’s style was so intimidating, those below her were afraid to speak out when she involved them in improperly transferring college money to her discretionary fund. In previous administrations, the president’s discretionary fund was rarely over \$5,000. In my estimation, Regina misspent at least a half-million dollars.” Taking the steps to prevent a situation like this would have been much more effective than dealing with the aftermath.

OTHER MISSING LINKS

Kranacher says others share responsibility for allowing this boondoggle to occur. “University officials didn’t insist on having an anonymous reporting mechanism, such as a hotline. I’ve now learned just how vital this is to the early detection of fraud. And the internal auditors for the university share a portion of the blame, too. Even though they were well-meaning, they’d had no antifraud training and therefore weren’t aware of the kinds of people who

are most likely to commit these offenses. In addition, the internal audit staff reported to the managers of the university rather than the board of trustees. When you have someone who is tyrannical, he or she must receive close independent scrutiny.”

A historical look at massive fraud cases supports Kranacher’s latter point: Barry Minkow of ZZZZ Best infamy, Ivan Boesky, WorldCom’s Bernard Ebbers and the Rigas family in Adelphia—the list goes on. Good CEOs are strong team players. Bad ones believe it’s their way or the highway. Kranacher is glad for the experience, but not eager to relive it.

“I lost a lot of sleep over this. I worried that by trying to find the truth I’d lose my job or get sued,” she told me. “Working on this case in a cloak-and-dagger fashion may sound exciting, but in reality it is quite unnerving. And finally, I am not sure how thrilled I am about being called Deep Debit.”

Ask probing questions and assess the response.

Answer Please: Fraud-Based Interviewing

BY JOHN J. HALL

EXECUTIVE SUMMARY

■ **ONE WEAPON AUDITORS CAN USE AGAINST FRAUD** is simply to speak to clients, managers and employees while observing their behaviors. Normal interview skills may be insufficient to determine whether an individual is withholding information, shading the truth or outright lying, so it's wise to learn fraud-based interview skills before they're needed.

■ **SAS NO. 99**, *Consideration of Fraud in a Financial Statement Audit*, paragraphs 20 through 26, specifies questions auditors should ask management and others in checking for fraud risk. The challenge is that those individuals committing wrongful acts and fraud can—and do—lie to the auditor or manager.


■ **IN A FRAUD-BASED INTERVIEW**, the auditor already has identified problems and is seeking to clarify their cause and quantify their impact. It presupposes that the subject has important information and may be misleading the questioner or lying. Members of an organization who may have knowledge of wrongdoing but aren't involved in perpetrating it are often a good source of information.

■ **FRAUD-BASED INTERVIEWS SUPPLEMENT** tests such as large sample sizes, computer-assisted audit techniques, observation, analysis and other cross-checks. They are useful when a subject gives answers that conflict with known information, attempts to direct questioning away from a sensitive area or topic, changes his or her attitude or cooperation level or

displays suspicious body language in response to certain questions.

■ **ALTERED OR FRAUDULENT DOCUMENTS** can tell a false story dispassionately, but “on the fly” responses to a prepared auditor’s questions often trip up fraudsters by revealing more than they intend—which is exactly the point of a fraud-based interview.

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 One weapon against fraud is simply to speak to people and observe their behaviors as you do so—something CPAs traditionally do during an audit. But when auditors and managers try to see into the gray world of wrongdoing and fraudulent financial reporting, normal interviewing skills may not be up to the task of determining whether someone is withholding information, shading the truth or outright lying. As with any audit procedure, it’s best to learn fraud-based interview skills *before* you need them on an engagement. Although not a comprehensive guide to in-depth forensic interviewing, this article can help auditors conduct focused discussions with clients, managers and employees to obtain additional information when suspicions become aroused. Such conversations may point to hidden problems, suggest where more investigation is warranted and possibly uncover deception.

START WITH THE STANDARDS

Statement of Auditing Standards (SAS) no. 1, *Responsibilities and Functions of the Independent Auditor*, says, “The auditor has 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.” SAS no. 99, *Consideration of Fraud in a Financial Statement Audit*, reiterates that concept and places a heavy emphasis on making inquiries. Paragraphs 20 through 26 list questions CPAs should ask management and others in checking for fraud risk.

It Adds Up

Financial statement fraud causes a decrease in market value of stock about 500 to 1,000 times

the fraud amount.

Source:

www.aicpa.org/antifraud.

Paragraph 27 is clear: “The auditor should be aware when evaluating management’s responses to inquiries...that management is often in the best position to perpetrate fraud.” Indeed, therein lies the challenge: Some people in positions of trust commit wrongdoing, and those committing wrongful acts and fraud can—and do—lie to auditors and/or managers.

WHEN SHOULD A NORMAL INTERVIEW BE MORE?

Imagine that audit interview skills form a continuum, with beginner skills at one end and forensic interview experience at the other. The fraud-based interview falls between those extremes.

At an early stage of the audit, auditors seek background information on an entity’s systems, procedures and controls. They may base queries on checklists or transaction flowcharts and ask clients and employees questions that require a simple “yes” or “no,” such as, “Do you reconcile the bank statement promptly at the end of each month?” Answers help establish the record of procedures a client claims to use and normally are validated by other information. At the other end of the skills scale, the forensic interviewer, experienced at designing and conducting interviews, tries to get subjects to reveal information they are attempting to shade or withhold.

A fraud-based interview comes after the auditor has identified problems and needs to clarify their cause and quantify their impact. It presupposes the subject has important information and possibly may be misleading the questioner or lying. In general, two types of subjects are of interest: people who are suspected of committing fraud and those who may have knowledge of wrongdoing but aren’t involved in perpetrating it. The second group often is a good source of information.

SORT TRUTH FROM FICTION

Fraud-risk indications may be present in documents, reports, exception statistics and behaviors, and there are many effective discovery-based tests auditors can perform, including large sample sizes, computer-assisted audit techniques, observation, analysis and other cross-checks. Fraud-based interviews supplement rather than replace those steps.

People who commit financial reporting fraud or misappropriation usually create plausible cover stories by blending elements of truth with fiction. They rely heavily on two tools: deceptive statements and falsified documents. People committing a fraud will lie, bend the truth, withhold or hide information and documents, and otherwise act to confuse, delay or block the path of the auditor—that’s why deeper questioning is called for. Potentially fraudulent documents aren’t really part of this

discussion, although you might use them during an interview.

Fraud-based interviews are a good idea when the auditor

■ ***Notes an important exception and cannot rule out wrongdoing as a cause.*** The auditor who tests exceptions and concludes they are not a result of error crosses a threshold—from performing a financial statement, controls or operational audit to early-stage fraud investigation.

■ ***Wants to follow up a routine discussion of procedures and controls.*** Auditors in organizations all over the world discuss and cross-check internal controls hundreds of times each day. Sarbanes-Oxley has intensified this compliance process for both internal and external auditors.

■ ***Suspects an interview response is fishy.*** For example, the subject gives answers that conflict with known information, attempts to direct the questioning away from a sensitive area or topic, or changes his attitude or cooperation level in response to certain questions. The subject also might suddenly avert his eyes, make hand or other movements or change posture, facial expression or speech patterns. Don't overreact to a discrepancy between body language and what a subject says, but do take the time to question more deeply.

■ ***Gets a tip that possible wrongdoing has occurred.*** A fraud-based interview can help confirm or disprove it.

UNCOVERING VERBAL DECEPTION

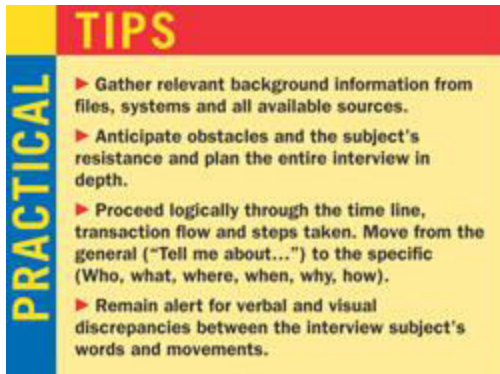
Lying is a learned skill for most people, who generally have little knowledge of how to lie and are uncomfortable doing so. Altered or fraudulent documents can tell a false story dispassionately, but “on the fly” responses to a prepared auditor’s questions often will trip up fraudsters by getting them to reveal more than they intend—which is exactly the point of an interview.

The following suggestions can help auditors plan a fraud-based interview:

Gather relevant background information. Before conducting an interview, gather as much background information as possible from files, information systems and all available sources. Include information on the interview subject’s background and responsibilities.

Organize, organize, organize. Anticipate obstacles and resistance and plan the entire interview in depth: opening comments, the body of the discussion, the introduction of documents into the interview and a closing strategy. Proceed logically through the time line, transaction flow and steps taken.

Move from the general (“Tell me about...”) to the specific (*Who, what, where, when,*



why, how?). Start with nonsensitive issues; ask questions to which you know the answer before proceeding to questions to which you don't. Ask the subject for the basis of any conclusions he or she expresses. Actively listen, both with your ears and with your eyes. If a verbal response and visual clues differ, probe deeper. Keep personal reactions, judgments, disagreements or suspicions to yourself unless expressing them is an intentional part of the interview plan. Above

all, keep the interview on track.

Structure the interview. Plan the three main phases of an interview. In the opening, make introductions, establish rapport, provide background information and observe. Develop your baseline for gauging the interview subject's veracity from observing his or her responses to questions to which you know the answers. In the middle (core) of the interview obtain information, asking the "Who, what, where, when, how, why?" questions. At the closing, confirm your understanding, reiterate key facts and agree on next steps, including suggestions about others to interview.

Use scripted questions if you need to. Many auditors prefer to work from a script, which will vary in formality with their experience and the specific situation. Simple bullet-point questions plus opening and closing remarks constitute an informal script. It's important to establish and maintain rapport with a subject, so if a script feels awkward and you think it will inhibit free-flowing dialogue, practice first. Interviewers of all experience levels occasionally forget crucial questions in the heat of the moment. Use the script to support the purpose and tone of the interview and to make sure you cover all important items.

Scripts also serve as a prop. They give the subject the clear impression that you are organized, prepared and focused on being thorough.

Use silence to your advantage. A long period of silence after a question has been answered, or during the time it takes the interviewer to record the answer, creates a vacuum that people tend to want to fill. That tension may provoke a subject to reveal cues that he or she is lying or withholding information. Quiet periods also give the interviewer an opportunity to assess the progress of the interview and change an upcoming question as needed.

Draw out additional details. Use questions or statements that elicit details such as

- "Can you walk me through an example?"
- "What happened next?"
- "How do/did you feel about...?"

Anticipate what might go wrong. Things rarely go as expected. Be prepared in advance to react. Make a list of things that could go wrong, and think through the actions you should or should not take in response to each possibility.

Control the discussion. Audits often expose problems and other issues and create a need for corrective action, so even routine financial statement audit procedures can be stressful to both auditor and client. When you actively probe for the cause of fraud indicators, your questions may peel away layers of fabrication and expose the truth. Be prepared for subjects to react with an abusive outburst attacking your qualifications, competence, integrity or some other feature. Don't let it detract from the task at hand.

Deal with reluctance. When sensitive issues come up, many interview subjects are reluctant to cooperate. This may be based on legitimate concerns about how much they should reveal to an auditor, fear of recrimination or disapproval for saying too much, cultural norms and business etiquette or even faulty memories. As much as possible, convey an attitude of cooperation. Use an interested, sympathetic tone in questioning and listening.

Take notes. Jotting down notes during the interview helps ensure accuracy, but be careful not to discourage rapport with the interview subject. If you're using a formal script, note taking should not interfere with your ability to observe visual cues that might suggest another line of investigation.

Be direct. Often the interview subject is an important executive or client representative. Auditors should be appropriately circumspect about the lasting impression the interview can create, but balance that against the need to get to the truth. Occasionally it may be necessary to ask a direct and potentially unsettling question, for example, "Do you know of any dishonest or fraudulent activity?" Be prepared to read the answer with both your ears and your eyes.

RESOURCES

AICPA Resources

On the Web

AICPA Antifraud & Corporate Responsibility Resource Center,
www.aicpa.org/antifraud.

Audit and attest standards team

Content on the AICPA Web site, www.aicpa.org/members/div/auditstd/index.htm, includes

■ Recently Issued Audit and Attestation Interpretations

www.aicpa.org/members/div/auditstd/announce/index.htm.

■ Auditing Standards Board exposure drafts, including recently issued proposed statements on defining professional requirements in statements on auditing standards (SASs) and in statements on standards for attestation engagements (SSAEs), as well as a proposed SAS on audit documentation, www.aicpa.org/members/div/auditstd/2005_02_28_prof_req.asp.

CPE

■ Auditing Update: A Review of Recent Activities, self-study text (# 732771JA).

■ Finding the Truth: Effective Techniques for Interview and Communication, DVD (# 760167JA).

JofA articles

■ [“A Practical Guide to Complying With SAS No. 99’s Key Requirements.”](#) May04, page 24.

■ [“Sherlock Holmes, CPA, Part 1,”](#) Aug.03, page 86.

■ [“Sherlock Holmes, CPA, Part 2,”](#) Sep.03, page 70.

■ [“Ten Steps to a Top-Notch Interview,”](#) Nov.02, page 99.

Publications

■ AICPA *Codification of Statements on Auditing Standards* (# 057194JA).

■ AICPA *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* (# 029879JA).

■ AICPA *Professional Standards*, paperback (# 005104JA); CD-ROM (# DPS-XXJA); online (# WPS-XXJA); looseleaf (# PS-XXJA). This publication provides all professional standards in one codified source, including GAAS and PCAOB standards.

For more information about these resources or to order, go to www.cpa2biz.com or call the AICPA at 888-777-7077.

Other Resources

■ PCAOB auditing and related attestation, quality control, ethics and independence standards and rules are available free of charge at www.pcaobus.org/standards/index.asp.

■ John Reid and Associates (www.reid.com), Chicago, offers in-depth training on fraud interviewing as do many organizations. Reid's instructors are familiar with the interview situations normally encountered by auditors.

DOES THAT ANSWER THE QUESTION?

A well-planned audit interview is an important way to gather and confirm operating data, answer questions, influence behavior and lay the groundwork for presenting findings and recommendations. Professional standards require CPAs to sharpen their skills to increase the likelihood of uncovering fraud if it exists.

You are more likely to discover fraud if you use these two simple steps:

■ Know what type of fraud can occur in the subject area you're looking into and describe to yourself what those fraudulent acts might look like.

■ Look carefully; that is, consciously employ discovery-based steps to uncover signs of fraud in documents, reports, exception statistics and behaviors. Besides using the many effective tests for auditing transactions and balances, enhance your likelihood of uncovering hidden issues by improving your interview techniques. The systematic use of a written script, long pauses between questions and attention to pacing all contribute to a successful outcome.

An audit seeks to verify a record of transactions and Sarbanes-Oxley has put more responsibility than ever on auditors' shoulders. If questioning points to potential criminality consider bringing in forensic interview specialists. The truth isn't "multiple choice." ■

Who a smart business owner calls to conduct an investigation.

When You Suspect Fraud

BY JOSEPH T. WELLS

The new general manager of a small manufacturing company knew something was amiss. Each time he asked the chief financial officer for critical cost information he got the runaround. “We don’t have a cost accounting system that can produce that information,” the CFO would say. Or, “I’m sure we have those data somewhere. Let me get back to you.” But he never did.

The manager had trouble convincing the company owner there might be a problem. After all, the CFO had been with the owner a long time and he was the company’s second-highest-paid—and most trusted—employee. Moreover, he was successful in his own right: He’d spoken at times of how he had taken the inheritance his wife received, invested it well in the stock market and prospered enormously. His ostentatious lifestyle certainly made that evident.

The CFO had complete control over the company’s finances, and was authorized to sign checks, perform bank reconciliations, post the accounting records and prepare the financial statements. And yes, the owner was aware that all that power could be subject to misuse. Still, he trusted his CFO.

The general manager was uneasy, however. The CFO was very secretive about his activities and always kept his office locked. A lot of his answers didn’t make any sense. Then one day the owner and the general manager were going over the payroll costs for the most recent period. The manager was shocked. “There is absolutely no way that our payroll is anywhere near that high,” he told the owner. “We’ve got to get to the bottom of this.”

OVER THE TOP

Getting to the bottom required the owner to go over the top, literally—he went through the ceiling of the CFO’s office. The owner crawled through the attic, removed some ceiling tiles and dropped into the locked office. In no time at all he found what he was

looking for: a number of the company's cancelled checks made payable to the CFO, signed and endorsed by the CFO and deposited into his personal bank account. The CFO also left a trail of documents: personal tax returns (which, not surprisingly, failed to declare the embezzled funds) and one bank account statement of his wife's. The tax returns showed the CFO wasn't such a sophisticated investor after all; he'd deducted significant losses from bad investments.

ENTER THE CPA

The owner contacted his lawyer immediately, who decided to bring in an antifraud expert. "The company was wise enough to avoid conducting its own investigation," said Rick Britt, CPA, head of litigation support and forensic accounting for Rhodes, Young, Black and Duncan, CPAs (www.rybd.com), in Duluth, Ga. "When a situation like this arises, it's time to call in someone with experience in fraud cases." Britt had that in spades: Before joining the accounting firm, the CPA and certified fraud examiner had spent nearly three decades with the Internal Revenue Service, rising to chief of Georgia's criminal investigative division.

Britt was hired to piece together what the CFO had done, to determine how much money actually was involved and to prepare the evidence in the event the case went to trial. "I don't recommend that clients directly retain a CPA when the possibility of litigation is involved," he said, "but rather suggest they hire a lawyer, who then can retain the expert. In this way, the CPA's work can be protected by the work product doctrine of the attorney-client privilege." (See "[The Attorney-Client Privilege](#)," below.)

The Attorney-Client Privilege

In order for the CPA/CFE's work product to be protected by the attorney-client privilege, the following four conditions must be met: The client must be the person who retains the attorney, the lawyer must be retained specifically to provide legal advice, and the client thereafter must communicate with the attorney on a confidential basis and the client must not waive the privilege. Business owners should contact their lawyers for details.

"As embezzlement cases go, this one wasn't very sophisticated," Britt said. "But gathering the evidence was made more difficult by the mess in the CFO's office. I spent the first several days just sorting through a stack of files about four feet high that was totally disorganized."

Then the CPA started seeing a distinct pattern. In reviewing the bank statements, he noticed a number of checks each month were missing. He asked the bank to produce copies and sure enough, those were ones the CFO had written to himself. Britt also said the CFO had recorded the amount of the checks missing for each month on the envelope flap of most of the bank statements. Presumably, they were destroyed so the owner would not notice them.

Britt located all of the missing checks and entered them into a simple Excel spreadsheet that showed the amounts, dates and other information. He documented a whopping \$3.7 million in losses to the small manufacturer over an eight-year period. As the

embezzlements got larger, so did the company's line of credit, which was needed to fund the fraud. The thefts were spread among a variety of company expense accounts so that no single account would be suspect.

THE LEGAL PROCESS

Once the losses were tallied, the company's lawyers successfully sought an injunction to prohibit the CFO from disposing of any assets he might have purchased with the stolen funds. Britt, who was qualified by the judge to be an expert in fraud matters, used the spreadsheets and copies of the checks to support his testimony at the hearing. (See [“Qualifying As a Courtroom Expert,”](#) below.)

Qualifying As a Courtroom Expert

Under rule 702 of the Federal Rules of Evidence, a witness qualified as an expert by “knowledge, skill, experience, training or education” may testify to an opinion based upon “scientific, technical or other special knowledge” if such testimony will “assist the trier of fact to understand the evidence or to determine the fact in issue.”

Although CPAs generally are regarded as specialists in accounting matters, there is no such thing as an automatic qualification as an expert witness. That determination is made by the presiding judge on a case-by-case basis.

“Fraud cases almost always involve volumes of documents,” Britt said, “and cases are won or lost on the strength of the evidence. It must be carefully preserved.” (See [“Evidence Preservation Rules,”](#) below.) Many frauds may seem outwardly complex, but they rarely are. Because CPAs are detail-oriented, there is a natural temptation to include too much information in exhibits, making them difficult and tedious for judges and juries to absorb. Good litigation experts like Britt remember three words: simplify, simplify, simplify. Another natural temptation for CPAs is to express opinions—especially opinions on guilt or innocence—when they should not (see [“Opinions on Guilt or Innocence,”](#) below).

Evidence Preservation Rules

For courtroom purposes, documents and other evidence must be carefully preserved in original condition until the time of trial. Here's what should be done:

- Log each piece of evidence and fully describe it.
- Mark each document with your initials and the date it was obtained.
- Make copies of the original documents to use as workpapers.
- Lock the originals away in a safe place so you can truthfully testify others have not had access to them.
- When you turn the original documents over to the court, obtain a signed receipt.

After obtaining a civil injunction against the CFO, Britt's legal team turned over the evidence to the district attorney's office. “Some people believe the victim must choose

between a criminal prosecution or a civil lawsuit, but that's not true," Britt says. "Parallel proceedings allow you to pursue both avenues simultaneously, and that's what we did in this case."

Opinions on Guilt or Innocence

The court alone makes the determination of guilt or innocence. In a courtroom, no good attorney would ask a CPA to express such an opinion, and no alert judge would allow it. CPAs also should refrain from expressing such opinions outside the courtroom. If, for example, you opine that a defendant was guilty and he or she is subsequently acquitted, you could find yourself being accused of defamation.

Even if you are not a certified fraud examiner, you can find guidance in the CFE Code of Professional Ethics, which states: "A CFE will obtain evidence or documentation to establish a reasonable basis for any opinion rendered. No opinion shall be expressed regarding the guilt or innocence of any person or party."

The DA's office issued subpoenas for the CFO's personal bank accounts. The evidence was revealing: He wasn't a sophisticated investor at all; he'd lost millions playing the stock market. He also had acquired two lake houses, two boats, a condo, expensive automobiles, jewelry for his wife and prepaid college tuition for his two children.

Because of Britt's efforts, the employer was able to secure both a criminal and a civil victory and recover about \$1.5 million from the defendant, insurance companies and other parties. The CFO, who pleaded guilty, was sentenced to prison and ordered to pay restitution.

Rick Britt has seen thousands of cases of fraud. He believes that CPAs who act as litigation experts must have a thorough understanding of their roles and be able to present testimony in a clear, concise and understandable manner. Or, as he succinctly puts it, "If it takes you more than a few sentences to sum up your case, you're going to have trouble in the courtroom." ■

