

## A Case of Client Fraud – Part 1

By Stephen Hollander, CFE, MIPI, CGA – February 2005

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This is the first in a series of articles on fraud and error. In this first part, the author discusses what to consider when asked by a hypothetical client to investigate a suspected case of fraud.

### **Case Facts**

*Joe Wittering, one of your most important clients, sounded worried when he called you at home last night, asking to see you first thing in the morning. When you asked what it was about, he told you that he'd rather not talk about it over the phone.*

*You've been doing review engagements for Joe's business for the past 10 years. Last year's statements showed the company with gross revenue of \$2.5 million and a net of \$500,000. The ratio of net income to revenue has been down slightly over the past two years, but this hasn't rung any alarm bells to date.*

*When you walk into Joe's office the next morning, it's obvious that something's bothering him. As soon as you sit down, he says, "I think that Maggie, our accounts payable clerk, has been stealing from us. It looks as if she's taken over \$200,000 over the past couple of years."*

*Silence hangs heavy while Joe waits for you to respond. What do you say now?*

In most accounting practices, it is rare for a client to come to you with a case of suspected fraud. One likes to think that this is because most employees are so honest, and most internal control systems are so effective, that fraud is itself a rare occurrence. The more bleak view is that most business owners simply don't realize that they're being victimized. In any case, if you find yourself in a situation such as the one described above, be careful! You run the risk of incurring major trouble if you overlook three unfortunate realities:

1. Most accountants have no idea how to conduct a fraud investigation.
2. Many accountants believe that they do know how to conduct a fraud investigation.
3. Attempting to conduct a fraud investigation without the requisite knowledge and skill can expose you, your client and your reputations to major legal and financial damage.

As Alexander Pope wrote, "A little learning is a dangerous thing." Most accountants receive only minimal exposure to fraud concepts in their introductory auditing course. While manipulation of accounting records is a factor in most occupational fraud incidents, accounting knowledge alone will not permit you to conduct a fraud investigation and bring it to a successful conclusion. Other required areas of knowledge include:

- Legal elements-including relevant criminal and civil law, rules of evidence, rights of accused and accuser, and expert witness matters
- Criminology-including theories of crime causation and crime prevention, information sources, and organizational issues

- Fraud investigative techniques-including development of predication, development of fraud scenarios, interviewing, statement taking, evidence gathering and handling, evaluating deception and report writing

What kind of trouble can you get yourself and your client into if you attempt to conduct a fraud investigation without being properly prepared? Consider the following scenarios related to Joe Wittering's company:

#### *Negligent Investigation*

As a result of your failure to document chain of custody of crucial records, key evidence against Maggie is ruled inadmissible in court. As a consequence, the case against Maggie is thrown out. Joe's company sues you for the full amount of the loss.

#### *Harassment*

You commence an investigation against Maggie on the basis of Joe's suspicions. The suspicions prove unfounded. Maggie initiates legal action against Joe, his company and you, for harassment.

#### *Wrongful Dismissal*

As a consequence of your investigation, you conclude that Maggie has indeed been stealing from the company. You set out your findings in a report to Joe, who proceeds to fire Maggie. Maggie sues for wrongful dismissal, and a court holds that your investigation failed to provide sufficient evidence to support the conclusions in your report.

#### *Defamation*

Maggie initiates legal action against you as a consequence of the unfounded accusations and unwarranted conclusions contained in the report that you prepared for Joe. Because your report was written, the defamation is libel rather than slander, and Maggie does not have to prove actual economic loss in order to receive an award of damages.

#### *Invasion of Privacy*

During the course of your investigation, you had the lock (which Maggie had supplied) cut off Maggie's locker in a search for incriminating evidence (which was not found). Maggie sues you and the company for invasion of privacy. Counsel advises you that Maggie had a reasonable expectation of privacy in her locker.

#### *Wrongful Confinement*

When you and Joe interviewed Maggie, Joe stood in front of the door, effectively blocking the exit. Maggie's suit alleges that you unlawfully confined her.

#### *Intentional Infliction of Emotional Distress*

During the course of the interview, Joe began yelling at Maggie, making threats, and pounding his fist on the table. Maggie's legal action against Joe, the company and you, includes a request for punitive damages for intentional infliction of emotional distress.

And it gets worse:

Maggie goes to the media with her sad story, and you find yourself fielding phone calls from the media and worried clients who want to know what in the world is going on.

You receive a notice from ~~the your~~ provincial ~~CGA Association~~ notifying you that you are being investigated for possible violations of several provisions of the Code ~~of Ethical Principles and Rules of Professional~~ Conduct. The investigation is as a result of the client and Maggie initiating an ethical complaint due to possible incompetence.

So, what do you do when a client asks you to undertake an investigation of a suspected fraud?

### **First of all, STOP**

Unless your practice normally includes forensic accounting, you may find your adrenaline rushing and causing you to say or do something imprudent. Then it's time to take a deep breath.

### **Find out where you stand**

If the company has indeed been defrauded, then the client may believe they have a cause of action against their external auditors. If they don't feel this way at the outset of the investigation, they may come to do so as the findings accumulate. "Why didn't you catch this earlier," becomes the refrain. Before proceeding with an investigation, be as certain as you can that you're not setting yourself up in a possible conflict-of-interest situation.

The mirror image of this is that a prudent client will likely not advise you about suspected fraud incidents until the issue of your potential liability has been considered. This means that you will become aware of the situation later than you would like. It also gives the client more time to make mistakes that could compromise the investigation. This brings us to our next point.

### **Find out how much damage the client has already done**

A business owner or manager, confronted with a potential fraud situation, may make serious mistakes by acting in the heat of the moment. You'll want to find out what the client has done so far, if for no other reason than to advise him about what else not to do. Some common errors include:

#### *Acting without sufficient foundation*

What is the basis of the client's suspicions? Are they reasonable? Are they based on an informant's information? What is the informant's motive? Have similar allegations been made in the past? Do the allegations make sense? Remember, if you begin an investigation without reasonable grounds, and later find out that your suspicions were unfounded, you won't be able to escape the consequences by saying, "Oops! My mistake!"

#### *Confronting the suspect or otherwise alerting them that their dishonesty may have been detected*

Unless there is an unusual situation, you should order your actions so that the suspect does not realize that they are under investigation until your client is ready. Your goal is to confront the suspect while in an act of dishonesty that cannot be explained away. You do not want to tip off the suspect so that they have time to alter or destroy evidence, concoct stories to explain what evidence remains, recruit alibi witnesses and otherwise frustrate your investigation.

In certain circumstances, your client may have to take overt action before you have completed the investigation. This may be the case, for example, if such action is necessary to prevent the loss of assets or to secure vital evidence. In such situations you will have to weigh the benefits to be gained from overt action against the consequences for the integrity of your investigation.

#### *Discussing suspicions with persons who have no immediate need to know*

Premature disclosure of suspicions may turn out to be defamatory. Also, for the sake of prudence, you should assume that at least one other person in the organization is involved in the fraud. As the posters said during World War II, "Loose lips sink ships."

#### *Reporting suspicions prematurely to regulatory authorities*

The authorities' overall objectives may not coincide with yours. If you are under a legal obligation to report fraud, this obligation generally attaches when fraud is discovered, not when fraud is suspected. Also, consider the possibility that the company itself might come under investigation by the authorities.

#### *Reporting suspicions prematurely to fidelity insurers*

Again, most clients' fidelity or commercial crime insurance policies require reporting of incidents when they are discovered, not when they are suspected. Reporting an incident to an insurer starts a clock ticking, e.g., deadlines for filing proof of loss. Also, you don't want the client's insurance company starting its own investigation and stepping all over yours.

### **Find out what evidence the client has**

There may be a reasonable and innocent explanation for what the client has interpreted as an indicator of fraud. The existing evidence may help you advise the client of the need for further investigation.

Your motives here may not be entirely altruistic. In the illustration given at the beginning of this article, the accountant had been performing review engagements for the business for 10 years. If it hasn't already, the question will eventually arise in the client's mind, as to why the accountant failed to find any warning signs that fraud was being perpetrated. Notwithstanding disclaimers in the engagement letter and in the report, it is possible that the issue of negligence may rear its ugly head. Finding out as much as you can about the client's suspicions and the supporting evidence provides you with the opportunity to review old files and ensure that all of the ducks are in a row.

### **Advise the client to engage the services of competent litigation counsel**

In-house counsel and most external general-practice lawyers do not have the expertise required to advise on the conduct of a fraud investigation. They may be very good at contracts, real estate, labour relations and other matters of a routine nature, but they may not be equipped to advise your client on matters related to evidence-gathering, interviewing or filing for a civil investigative process.

Another point to consider is that there is, in Canada, no such thing as accountant-client privilege. Any communications between you and your client may be discoverable by an adverse party if the matter should go to trial. On the other hand, communications made to a lawyer in contemplation of litigation may (although not necessarily will) be protected by privilege.

Yet another consideration is the matter of your fee. Investigations are expensive, and clients have been known to balk at the size of the billings submitted by their accountants. This is particularly the case if the results of the investigation are not what the client expected. If the client refuses to pay, you may find yourself in a situation where you are forced to write off a sizeable sum. If, on the other hand, you have been retained by counsel, the lawyer has a professional and ethical obligation to pay your reasonable fees (presumably set out in your engagement letter). According to [2.2 Chapter 2 section 2](#) of the Professional Conduct Handbook of the Law Society of British Columbia:

*The lawyer has a professional duty, quite apart from any legal liability, to meet professional financial obligations incurred or assumed in the course of practice, such as agency accounts, obligations to members of the profession, fees or charges of witnesses, sheriffs, special examiners, registrars, reporters and public officials when called upon to do so.*

### **Consider your own expertise**

As noted at the start, you can get yourself into all kinds of trouble if you overreach your own expertise. To put it simply, you have a legal and ethical obligation to know what you are doing.

Remember also that any investigation that you undertake may well develop into litigation that will end up in court. The investigative process will be reviewed in minute detail by experienced defence counsel who have the benefit of hindsight. If you are at all unsure that your work would withstand such scrutiny, refer the client to a firm of professionally qualified forensic investigators - or, possibly have the client's litigation lawyer recommend a satisfactory firm.

### **Obtain an engagement letter**

The purpose of this letter will be to ensure that both you and the client understand the nature and scope of the work that you propose to undertake. Because each fraud investigation is unique, it is not possible to provide a "cookie cutter" engagement letter comparable to those used in audit or review engagements. Some points, however, generally apply:

- Following the advice in point five above, your services should be retained by counsel and not directly by the client. Accordingly, your engagement letter will be addressed to retaining counsel rather than to the client.
- State the purpose of the engagement; that it is undertaken in contemplation of possible litigation.
- State that you will investigate the situation and report your findings only to the lawyer-not directly to the client. To protect solicitor-client privilege further, briefings to management of the client should be given only upon advice of the lawyer, and preferably in the lawyer's presence.
- Avoid language that indicates that you or the client have prejudged whether fraud has occurred or the identity of the suspected perpetrator(s).
- Set out the calculation of your fees (presumably charged out at an hourly rate) and the timing of payment. Investigative engagements are labour intensive and can go on for a long time. You probably don't want to carry tens of thousands of dollars in unbilled work in process. For an investigation of any meaningful size, the engagement letter should provide for interim billings on a monthly basis, with a recitation that continued work on the engagement is contingent on prompt payment of your billings. If the client is not one with whom you have had a reasonably long or good history, you may wish to ask for an up-front retainer as well.

Stephen Hollander, CFE, MIPF, CGA, is the Economic Crime Studies Program Coordinator at the British Columbia Institute of Technology (BCIT).

For information on forensic accounting courses available through BCIT, contact the author at [Stephen\\_Hollander@bcit.ca](mailto:Stephen_Hollander@bcit.ca) or view their Web site at [www.bcitforensics.ca](http://www.bcitforensics.ca).