BY-LINED ARTICLE

Tips to Prevent and Mitigate Fraud in the Family Office

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Lawyers often have expressed or implied fiduciary oversight responsibilities in connection with the "family office" of wealthy individuals, families and private foundations. The term "family office" is commonly used to refer to financial services needed by or provided to wealthy or aging families. Services typically include property management, investment management, bill paying, accounting and household payroll, tax preparation and planning, family governance, philanthropy coordination and succession planning.

Historically, family office services were managed by large financial institutions and large accounting firms. Over the last decade, however, many aging or wealthy families have turned to small accounting firms, bookkeepers or specialty shops. While some of these advisers may be CPAs subject to certain ethical standards and licensure requirements, many are unlicensed and unregulated.

The news is filled with new stories of bookkeepers and others responsible for safeguarding assets or providing financial services being charged with embezzlement and other frauds. In today's fast-paced and rapidly changing and aging environment, along with the current economic challenges faced by individuals and businesses, it is critically important that the financial affairs of your family office clients be managed with the utmost integrity, whether or not you are watching.

There is documented evidence of increasing levels of financial abuse of seniors who no longer handle their own financial affairs and place their trust in others to do so. According to the U.S. Department of Health and Human Services Administration on Aging Division, approximately one in eight individuals was age 65 or older in 2007. Sheer numbers alone point to increasing opportunities to provide services to this segment of the population. However, it also opens the door for unscrupulous and unethical advisers to take advantage of those in need of financial assistance, often when they are preoccupied with big picture activity, declining health or other distractions.

Few entities are at greater risk of or have more exposure to fraud than the family office, where there may be no internal controls, segregation of duties and little or no oversight of those managing the bookkeeping and cash flow functions. When working with your family office clients, it seems prudent to consider the implications and potential presence of fraud characteristics, also known as fraud risk factors. A fraud risk factor is an event or condition that may make an environment susceptible to fraud. The three conditions or risk factors are incentive, opportunity and rationalization. Although fraud risk factors do not necessarily indicate that fraud exists, they often are warning signs.

Incentive, or motivation to commit fraud, may exist in difficult economic times when individuals may be having trouble paying their bills. An opportunity to commit fraud could arise in situations when there is a lack of internal controls or insufficient oversight, which is often the case in family office environments. The individual incentive and the presence of opportunity combine to increase the likelihood of an occurrence of fraud. Perpetrators of fraud will also devise rationalization concepts, such as, "I'll pay the money back when my situation improves," in an attempt to justify their actions.

Many CPAs provide support to family offices through programs that may include flexible suites of accounting, finance, tax and customized administrative services. When CPAs are not performing the internal family office services (bookkeeping, check writing, etc.), they are often engaged by counsel to perform examinations to ascertain whether evidence of fraud has occurred in the management of the client's affairs. These examinations may also determine if appropriate safeguards are in place to minimize the opportunity for inappropriate activity.

Often, these examinations are requested, and occur, when suspicions of inappropriate activity have been in place for some time, or worse, when a fraud has already been perpetrated.

It is not always possible to detect and prevent a fraudulent activity from occurring. However, it is very possible to avoid or limit fraud. With effective due diligence by or under the supervision of counsel and deployment of safeguards, risks can be minimized. Select due diligence and safeguards may include the following:

Pre-employment

- Personally interview a bookkeeper or other professional to handle the affairs of your clients.
- Perform criminal background and credit checks.
- Follow up directly with references provided and document the discussions' salient points.
- Utilize your network to locate other references not provided by the candidate, since applicants will rarely provide negative references and employers may be unwilling to confirm nature of employment circumstances beyond time frames of employment and compensation.
- Actively verify experience in all required areas of expertise for your client's particular situation. Experience, in addition to basic accounting and bookkeeping, may be required in the areas of investment operations and management, finance and consulting.
- Consider administering technical tests such as bookkeeping and computer software tests.

Operational and ongoing

- Arrange for loan statements, bank and credit card statements, and other important routine documentation to be sent directly to you for distribution to the bookkeeper, providing you with a general idea of the types of transactions that should routinely be processed.
- Use online access to obtain routine bills and other documentation. This is a basic tenet of internal accounting control – have the mail received and opened by someone other than the person charged with the responsibility of paying the bills or making bank deposits – not always possible in the family office environment.
- Scan bank statements for unusual transactions.
- Scan processed checks for possible forgeries or inconsistent signatures or endorsements.
- Scan deposit slips for deposits less than the full amount of the checks deposited, such as in "cash back" deposits.
- Investigate abrupt changes in power of attorney authorizations.
- Investigate unanticipated insurance policy and beneficiary changes.
- Watch for illogical patterns and increased ATM and cash withdrawal activity.
- Beware of unexpected changes in real estate holdings.
- Have the accountant or bookkeeper bonded by a reputable bonding company.

- Verify that appropriate accounting systems are in place with reputable vendors providing adequate levels of support. Do not accept "spreadsheet accounting," as the audit trail will be compromised.

Forensic CPAs

Although lawyers need not become experts in the methods of bookkeeping and accounting, they should not put blind faith in those managing the affairs of their clients. Be involved and aware.

In many cases, forensic CPAs are consulted in advance of any suspicion or occurrence of fraudulent activity to determine if appropriate safeguards are in place to minimize the opportunity for inappropriate activity. Occasionally, these consultations uncover evidence of fraud, unbeknownst to the advisers of the family office. At other times, the CPAs who typically perform the investigations are often providers of family office services, another risk minimization approach.

In the event a client has been a victim of fraud or other type of financial exploitation, a federal theft tax deduction may be allowed. Theft losses are deductible if they result from acts illegal under state law, such as fraud and embezzlement, provided the acts are committed with criminal intent. Theft losses require significant burdens of proof and often "red flag" a tax return for audit. Appropriate documentation must be obtained and substantiated through appropriate investigation and analysis. Therefore, when engaging a CPA to provide forensic services, it is recommended that forensic CPAs with significant tax expertise be utilized.

This article is intended to provide some insight into the increasing potential for fraud in your family office client matters. An ounce of prevention is worth a pound of cure, as the saying goes. The more focus that is placed on the potential for fraud through risk factor awareness and the implementation of related prevention and detection activities and procedures, the lower the chance of an actual occurrence.

If you suspect fraud, or merely wish to ensure that the risk of fraud is minimized, consult with CPAs well-versed in fraud detection and prevention and related tax implications. Do not allow the red flags of fraud to continue to fly. You, as well as your clients, will benefit greatly.

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