

Effective Wealth

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A Prudent Perspective and Practical Methods for Preventing Fraud

Anyone who works closely with family offices can appreciate what complex business organizations they can be. Since there is no standard template for managing family offices, they tend to develop business models that define their unique characters. Diverse practices evolve over time based on each family's traditions, values and loyalties.

This poses a problem in today's complex environment as each day's headlines announce new examples of fraud, embezzlement, theft or negligence. Every type of business is vulnerable to these threats and must take precautions. For family offices, the vulnerabilities can be substantial for many reasons, including their intricate relationships, diverse cultures, dispersed responsibilities and perhaps also some degree of complacency.

Based on experience, we believe many family offices find it difficult to develop effective fraud-prevention programs due to conflicting values. On one hand, they want to avoid incidents of fraud and the attendant liabilities, losses, negative publicity and family friction. On the other, they want to preserve traditions, such as trusting loyal staffers or making business transactions convenient for family members.

A first step in resolving this conflict can be to develop a perspective of prudent awareness. New ways of thinking and planning can be set in motion through a fraud-prevention audit, a process conducted by specialists in forensic accounting techniques who also understand the complexities of family offices. Typically, an experienced team evaluates the family office's personnel, operations, records, accountabilities and controls. It then identifies specific vulnerabilities and makes recommendations for reducing risks.

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Minimizing Exposure to Risk and Fraud

The priorities of single and multi-family offices often vary, but a common objective is the focus on the protection of the family's assets. Like most businesses, family offices are exposed to certain risks that can deter them from achieving their goal of protecting the family's interests. The most common areas of risk management in a family office include business process risk, technology risk, and fraud risk.

The sooner that an operational risk management (ORM) program is implemented in a family office, the better equipped it will be to manage risk and discourage inconsistency and unreliability in the management of the family's financial and business affairs.

Internal controls are procedures that a family adopts to build integrity and security into its critical processes that may help mitigate many of the risks found in a family office environment. Internal controls are not designed to prevent every occurrence of error or fraud, but they can be a very effective tool in reducing and managing risk, and a vital complement to the family's governance strategy.

Many of the operational risks that family offices face revolve around the office's specific processes for managing cash and investments. The potential for the misappropriation of funds, improper authorization of investment transactions, inaccurate recordkeeping, and lack of timely financial reporting can hinder decision-making and prevent the family from achieving its objectives.

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This process can increase awareness and vigilance whether or not a family office accepts all recommendations or implements changes quickly. At minimum, it will encourage constructive communications between family members and help to modify routines that may seem innocuous, even though they are known to invite fraud.

As a next step, a family office can implement a series of practical methods identified in this article for increasing controls, creating checks-and-balances, and outsourcing critical services. Most of these methods can be adopted without disrupting family traditions and at fairly modest cost and organizational impact.

A PERSPECTIVE OF PRUDENT AWARENESS

In criminal law, fraud is usually defined as deliberate deception with the intent to harm a victim. A family office should take a broader view and include acts that may be unintentional, negligent or caused by lack of knowledge. Such broad awareness should encompass both internal acts, performed by office staff or family members involved in the business, and external acts, such as most types of investment management fraud.

A prudent perspective can be created, in part, by educating office staff and family members on three red flags comprised by the “fraud triangle,” because they have repeatedly created conditions for criminal fraud incidents. According to the accounting profession’s Statement on Auditing Standards No. 99, (SAS 99), they are:

1. Pressures or incentives motivating the perpetrators to act—such as personal financial problems or personality conflicts.
2. Opportunities for fraud, often created by a lack of oversight or controls.
3. A negative attitude, lack of judgment, or absence of morals on the part of perpetrators.

Of course, high-profile fraud can be committed by coordinated groups of people or criminal rings. In family offices, and especially in cases of deliberate internal fraud, we have found that perpetrators usually work alone. Typically, they have earned positions of trust and are given relatively unchecked access to accounts, funds, reports and statements. They tend to thrive on lack of communication—not having to provide reports or share information with others—and consistent business rituals, such as the fact that family members often do not read business mail or require reconciliation of accounts.

BENEFITS OF A FRAUD PREVENTION AUDIT

Since 2002, independent auditors have been required by SAS 99 to interview the management teams of their clients to discuss how financial statements might be susceptible to

material misstatements due to fraud. Although SAS 99 has increased anti-fraud vigilance in the aftermath of the Worldcom and Enron scandals, family offices should not rely on their financial audits for fraud protection.

A dedicated fraud-prevention audit provides an objective third-party assessment of vulnerabilities before they are identified and exploited by perpetrators. In addition, it can help to:

- Evaluate the family office’s management structure and its managers’ ability to delegate responsibilities, provide accurate reports, and monitor day-to-day activities.
- Identify specific opportunities to increase expertise and controls through outsourced relationships.
- Establish effective protocols for such activities as wire transfers, maintenance of books and records and timely financial reporting.
- Increase professionalism by hiring staff on the basis of thorough background checks and requiring segregation of specific staff duties.
- Document investment policy for the family office and create consistent standards for due diligence, investment decision-making, and performance monitoring and reporting.

A fraud-prevention audit can help family offices treat their affairs and assets as a serious business in which all participants are held to clear, consistent standards.

METHODS FOR PREVENTING FRAUD

Although each fraud-prevention audit is customized to the client’s needs, our recommendations often include a series of practical methods that have proven effective in discouraging fraudulent activity.

Vary the routine

Acts of fraud occur and continue when opportunities arise from daily routines and repetitive patterns. For example, some family offices regularly dispense cash through physical deliveries made by the same person, traveling the same route at the same time of day or week. We recommend that large amounts of cash be delivered by a professional service provider, such as Wells Fargo. But if this isn’t feasible, we recommend varying the routine, with different people assigned to the task to increase checks-and-balances.

Open the mail

One of the simplest ideas to implement can be among the most effective: *Just open the mail.* We encourage family members to open any mail addressed to them that contains financial documents such as bank and brokerage statements, capital letters, credit card bills, and invoices. Even if a family member lacks the time to read or

check these documents, opening the mail before it's distributed to the office staff can discourage fraud, because perpetrators thrive on patterns of disinterest or neglect.

Segregate duties

Simple rules for segregating related responsibilities can be effective. For example, the person who writes the checks should not be the same person who receives the bank statements and reconciles the bank accounts. The person who maintains the general ledger should not reconcile the bank accounts and write checks. Bank deposits should not be made by the same person that records the deposits and reconciles the accounts. Following these rules helps to eliminate opportunities for covering up theft with false records or destruction of documents.

Outsource the basics

Another time-tested idea is to outsource basic accounting and bookkeeping services, including check-writing. Engaging a professional service firm to maintain accounts and write checks can deter fraud, especially if the accounting firm has a fraud-prevention perspective.

Ensure financial reports are complete and timely

Whether financial reports are prepared by internal staff or an outside accountant, they should follow consistent formats and schedules. The more time that elapses between events and reports, the more room fraud perpetrators have to maneuver. A complete set of financial reports should include, at minimum, an operating statement comparing budget vs. actual results, and a statement of net worth including updated and reconciled asset values for alternative investments and brokerage accounts.

Establish procedures for check-signing

Dual check-signing authority is not necessary for paying day-to-day bills in small amounts, but it should be required for all expenditures over a pre-determined amount, such as \$10,000. We recommend a requirement that large checks have two signers—one from an accounting firm and the other from a designated family member or office manager.

Set protocols for wire transfers

Wire transfers are notorious vehicles for fraud, especially when money is wired from an internal account to an external bank. Unlike an internal transfer (e.g., between family accounts), there may be limited ability to recover a fraudulent external wire transfer. Before such a transfer is made, a protocol should be followed for having the family office's bank call back a designated individual (other than the person requesting the transfer) to verify approval. We recommend that this protocol be followed regardless of the wire transfer amount or external bank used.

Conduct consistent background checks

Before hiring staff involved in financial transactions, procedures should be set and followed for conducting personal background checks. These procedures should be enforced without fail, even when an employment candidate is a "family friend" or comes highly recommended by an impeccable source, such as another family office.

Set clear, documented investment policies

We've evaluated many structures that family offices use in vetting, selecting and monitoring investments. While flexibility has advantages, we also think that a few basic guidelines are advisable:

- Important investment decisions should be made by designated family members, on behalf of the whole family. Fragmented investments made on behalf of specific members, to the exclusion of others, often lead to family friction and, ultimately, a dysfunctional family office.
- Strong family offices hire a dedicated investment professional as Chief Investment Officer (CIO) to conduct due diligence and make recommendations. It is essential to review the track record, experience and background (including references, criminal record and credit check) of any CIO candidate. Make sure the CIO is producing original work and is not acting as a conduit for recommendations from other entities.
- Strong family offices encourage investment transparency and communications. They have a documented Investment Policy Statement that prohibits opaque or highly complex arrangements. They establish a committee of key members to fully debate and approve (or disapprove) specific recommendations made by the CIO. They demand full and consistent due diligence on every investment considered, especially "pet projects" of individual family members.
- Offices can create checks-and-balances by outsourcing responsibilities for data aggregation, performance reporting and analysis, and tax reporting. An experienced accounting firm also can help to verify the accuracy and consistency of capital letters received from alternative investments, including capital contributions and withdrawals.

A PROCESS FOR INCREASING PROTECTION AND PEACE OF MIND

In today's complex world, fraud can occur anywhere and to almost anyone—including sophisticated investors, operating companies and individual victims of identity theft. The Internet has enabled fraudulent acts to be committed against U.S. residents by criminals operating in foreign jurisdictions, while an economic downturn has exposed new types of fraud—such as vast rings of mortgage market manipulators.

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Minimizing Exposure to Risk and Fraud

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Technology risk is often prevalent in family offices. Many family offices use technology extensively to communicate with clients and family members, manage finances, execute transactions, and prepare reports. While technology has increased the efficiency of many family offices, it also exposes them to many risks, if not implemented carefully, or monitored regularly. Common areas of technology risk include information theft, breaches in confidentiality, unauthorized user access, and system issues in communicating with institutions and advisors.

Risk due to occupational fraud has gained more heightened awareness within family offices. During challenging economic times, it is imperative that the family office increase their awareness of fraud potential. Many cases of misappropriation of assets, defalcations, and irregularities could quite possibly have been prevented if a proper system of internal controls was adopted. Family offices are subject to employment risks including payroll risk, embezzlement, and tax and other financial reporting issues.

NEXT STEP IN MITIGATING RISK AND FRAUD

A family office should seriously consider engaging in an ORM assessment. It will benchmark the existing processes and controls to the best practices of other family offices based on the risks and objectives of that particular family office. This gap analysis will assist in identifying the existing vulnerabilities of the family office and will lead directly to the development of sound governance and the beginning of an effective internal control program.

The ORM assessment is the first step in implementing best practices into the family office's culture to enable strategy and decision-making based on sound, prudent management. [®]

By Joseph D. Zarkowski, CPA, Principal

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Of course, family offices are vulnerable to many types of fraud, ranging from elaborate swindles to petty theft. Often, acts that can prove costly and damaging fall outside the legal definition of fraud as "deliberate deception." They can even be the result of casual or unintended mistakes that aren't detected, reported or corrected.

This is why we advocate a fraud-prevention audit as a process for changing the perspective of family offices and implementing practical methods that have consistently worked. You don't have to change your unique, defining values to treat your office as a serious business and increase its protection and peace of mind. [®]

By David Kaufman, CPA, Principal

For more information on this article and for services offered by Rothstein Kass, please contact David at 917.438.3970 or via e-mail at dkaufman@rkco.com.

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David Kaufman provides accounting, audit, tax and business consulting services to privately held, family owned businesses, and their owners. He has over 25 years of experience in the accounting profession and has extensive experience in providing financial, tax and consulting services to family offices and their members.

David received a B.S. in accounting from Brooklyn College and has taken courses in the Masters of Taxation program at Baruch College. In addition, he has been accepted as a certified fraud examiner (CFE), which signifies that he has the expertise to identify and investigate possible fraudulent activities of businesses and individuals and has extensive experience in providing litigation support services and serving as an expert witness. He has provided vital information in cases dealing with defalcations, misappropriation of funds, damage claims and related calculations, and other fraud related issues.

David is a member of the New York State Society of Certified Public Accountants (NYSSCPA) and the American Institute of Certified Public Accountants (AICPA), and he serves on the Board of Directors of numerous charitable and philanthropic organizations.

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