



Financial Fraud Law Report

AN A.S. PRATT & SONS PUBLICATION

OCTOBER 2013

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Why Attorneys Use Forensic Accountants in Litigation Cases

MARK S. WARSHAVSKY

This article focuses on the litigation aspects of forensic accounting.

The profession of forensic accounting, although dating back to the early 19th century, has generated public attention in recent years as a result of several charges of securities fraud, among other offenses, committed by officers of large companies, such as Enron and WorldCom. In addition, after the terrorist attacks on the United States on September 11, 2001, the CIA and the FBI utilized forensic accountants to follow the terrorists' trail of money in an effort to obtain enough evidence for an arrest. These events and similar developments, as well as the related investigations and ensuing trials, have highlighted some of the services that a forensic accountant can perform for attorneys and businesses. Although forensic accounting assignments can include both litigation and non-litigation matters, this article focuses on the litigation aspects of forensic accounting.

Through the years, several well-known cases have involved various aspects of forensic accounting. Bernard Madoff's multi-billion dollar Ponzi investment scandal, the largest in history, struck a blow to an already wobbly U.S. economy. Forensic accountants were hired by the court appointed trustee to follow the flow of funds and to reconstruct multiple sets of books and records, from their beginning through many layers of transactions, in order to uncover misappropriated assets that could ultimately be returned to the defrauded investors.

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WORKING WITH THE ATTORNEY

For many attorneys, retaining the services of forensic accountants has become an integral part of resolving their clients' legal battles, either before or during litigation. This need for forensic accountants in litigation results from financial disputes that require specialized knowledge in multiple financial disciplines. Attorneys can engage forensic accountants to assist in translating complex financial matters into a more understandable format. Frequently, these financial topics are a key factor in the ultimate outcome of the lawsuit.

It has been said that forensic accountants operate in a world of mystery, intrigue, and excitement, while still utilizing core accounting skills. Their work, which can be thought of as solving a technical puzzle that is filled with numbers and that sometimes requires a reconstruction of the pieces, fluctuates between calm periods of routine tasks and unpredictable shifts into emergency mode in order to meet an attorney's quickly approaching deadline.

Because of the forensic accountants' financial acumen and a sleuth mentality, they have been compared to Arthur Conan-Doyle's legendary detective Sherlock Holmes, renowned for his astute logical reasoning and adept forensic science skills. Forensic accountants are similarly proficient at inquiring, identifying, investigating, testing, and analyzing financial information, in conjunction with identifying the individuals associated with the case, in an effort to follow the money. Ultimately, the financial forensic results may uncover hidden assets, identify the source of unreported income, determine lost profits, expose financial statement fraud, or aid the attorney in whatever specific financial issues that a case might require.

TIMING OF RETENTION

The early hiring of forensic accountants can influence the outcome of the case; this allows them to assist the attorney in a variety of ways, such as making a preliminary assessment on the merits of the litigation and developing strategies related to the discovery of relevant documents.

An integral part of any litigation case is the type of documents an attorney receives; this is a critical stage in the process, and may result in an attorney's determination of the claims to be made, probability of uncovering the potential improprieties, and formulating strategies. Forensic accountants

have the ability to identify the financial elements that are pertinent to the case specific fact pattern, and possess the knowledge to adopt, and execute, the requisite investigative techniques.

During the document inspection phase, various types of data exist, usually in a variety of formats, and forensic accountants can distinguish what should be requested. Thus, the forensic accountant's application of the *full and false inclusion* concept can be pivotal in determining the appropriate universe of data under investigation; and may ensure that no extraneous data is included, and that appropriate data is not excluded. This process commences at the inception of the case, and is continuous throughout the duration of the litigation assignment. After the information has been received, forensic accountants can interpret the financial data to determine its relevance, and significance, to the particular facts of the case.

LITIGATION SERVICES

Some areas of litigation where forensic accountants can be of assistance, and some examples of the types of services within these areas, are discussed below. These examples represent only a small segment of the versatility that forensic accountants possess and the assignments that they are equipped to handle.

Shareholder/Partner Disputes

In certain cases, forensic accountants determine the company's income stream as part of a business valuation for a buyout pertaining to one or more of the shareholders or partners. They may also investigate whether any additional undisclosed companies may exist, quantify damages associated with allegations for breach of fiduciary duty, identify fraudulent transfers and other illegal activities, and investigate claims related to a court filing for dissolution of the company.

Matrimonial Dissolutions

When assisting with matrimonial dissolutions, forensic accountants may determine whether unreported income or hidden assets exist. When a close-

ly held business is part of the marital estate, they investigate the company's books and records and value the business; they also may complete a marital versus separate property analysis, perform asset-tracing procedures, and prepare an income stream or lifestyle analysis.

Breach of Contract

In such cases, forensic accountants determine damages or lost profits when one of the parties to the contract has not performed, or has interfered with the other party's performance.

White Collar Criminal Investigations

Forensic accountants assisting in white collar criminal investigations may utilize data mining software to investigate the financial records; analyze third party documents, such as bank statements, in order to identify suspicious transactions; and conduct fact finding interviews.

Bankruptcy

In bankruptcy cases, forensic accountants may investigate claims of fraudulent transfers or preferential payments; examine a debtor's assets and liabilities to determine whether the company is solvent; and perform a liquidation analysis.

Due Diligence

In mergers and acquisitions assignments, forensic accountants investigate financial activities for one of the companies prior to the transaction; and may also examine claims of post-acquisition disputes.

THE FORENSIC ACCOUNTANT AT WORK

Under generally accepted auditing standards, an audit focuses on whether a company's financial statements are presented with a reasonable assurance that no material misstatements exist. Audit procedures are performed on a sample

basis, because a detailed examination of every transaction is not the objective; however, in a forensic investigation, where materiality is not a factor that affects the scope of the work, sampling procedures are generally not preferred. An examination of specific transactions of all sizes, both large and small, is typically implemented in order to determine trends and identify patterns in the data. Thus, forensic accountants might determine that investigating even the smallest transactions is the key to uncovering a fraudulent activity.

There are several definitions of forensic accounting, including “the art and science of investigating people and money.”¹ In this sense, financial forensic tools and techniques are employed in tandem with an investigation of individuals, many of whom might initially appear to be unrelated to the litigants. The money related deception, which can occur through journal entries, financial statement manipulation, and other fraudulent methods, often can only be detected when a forensic accountant develops an understanding of the people involved.

Due to the unique circumstances of each case, the forensic accountant’s role can differ from one assignment to another; it might even change as a case advances through the litigation process. Each case contains many different points at which attorneys can benefit from the services of forensic accountants; these can be divided into four general phases, with the following examples for each:

- *Foundational* — Forensic accountants provide assistance in the case development and discovery stages, and assist in defining the financial framework of the case. They also assess the quality of the documents in order to determine which information might be relevant.
- *Interpersonal* — During this phase, forensic accountants conduct interviews to aid in planning and executing the collection of case data; in addition, they perform background research on the people and entities relevant to the matter.
- *Data collection and analysis* — Forensic accountants accumulate data and marshal the necessary analytical tasks to either support or refute the theories presented. If requested, they also assist in any hearings, conferences and settlement negotiations.

- *Expert report and trial* — In this stage, all of the forensic accountant's conclusions during the assignment are aggregated, followed by the submission of a report and possible testimony at deposition or trial. If requested by the attorney, the forensic accountant can critique the opposing expert's report.

Each of these phases can be expanded to provide forensic accountants with a greater role in the litigation process. For example, when providing assistance in the data collection and analysis phase, forensic accountants can investigate the financial documents received, perform research, and then apply financial forensic tools and techniques, such as trending, benchmarking, and ratio analysis. Depending on the case requirements, the forensic accountant might also deploy digital analysis techniques by using data mining software to test for anomalies in digit patterns.

TOOLS AND TECHNIQUES

As previously mentioned, it is essential that forensic accountants identify the specific needs for each case, and then determine the most appropriate application from the available tools and techniques. In applying these procedures, the forensic accountant might need to utilize a combination of financial skills (e.g., accounting, auditing, finance), along with certain non-financial qualities, such as persistence, creativity, judgment, discretion and adept communication skills. This collection of attributes, combined with an inquisitive mind, aids forensic accountants in investigating and assessing the financial merits and integrity of a litigation case's distinct aspects. By integrating these varied disciplines, the forensic accountant's examination of both the financial and non-financial information can furnish the retaining attorney with invaluable insight at every juncture of the case, especially as additional events occur or facts become known.

The following forensic applications, a narrow selection of examples taken from a wide array of forensic accounting tools and techniques, can be integrated into an investigation if they are applicable in the specific case:

- *Benchmarking* establishes a baseline for comparison of an entity, either through its historical performance or the performance of its peers in the industry.

- *Benford's Law* analyzes digits and digit sequences that are expected to follow a predictable pattern in a data set and identifies possible errors, potential fraud, or other irregularities.
- *Data Mining* electronically analyzes large amounts of financial data from spreadsheets or database files to identify digit and number patterns.
- An *Entity Chart* is a visual representation depicting entity(s) and owners, as well as relationships among them. It is usually prepared early in the assignment and continually refined as the assignment progresses.
- *Forensic Lexicology* is the study of words and vocabulary and how they are used, which can be employed to analyze responses during interviews, depositions and other inquiries.
- *Gap Analysis* involves identifying items unaccounted for in a sequentially numbered or dated set of documents or transactions. The gaps may indicate intentionally omitted items.
- *Genogram* is a visual representation of the relationships between the subject individual and any related, or unrelated but relevant, parties. This process charts relationships that might otherwise be missed, which can lead to asset or income diversion sources.
- *Link Analysis* establishes associations, known as links, between people and data that might not otherwise be apparent from an examination of isolated data.
- *Timeline Analysis* represents a sequentially prepared visual analysis for the timing of relevant events, including both financial and non-financial activities.

ADDING A POWERFUL DIMENSION

When attorneys can present quantifiable data in a convincing format, that is unmistakably understood, they can frequently achieve crucial leverage in their case, whether it is at the negotiating table or in the courtroom. Most often, information presented by an attorney will be received favorably when it is substantiated by irrefutable facts. Forensic accountants bring professional skepticism and a suspicious nature to their assignments, along with a willing-

ness to look beyond the numbers, as presented, to investigate and uncover the actual intent of the transactions. The attorney who retains a forensic accountant adds a powerful dimension to the professional team to help present or defend claims.

NOTE

¹ Consultants' Training Institute, <http://www.nacva.com/CTI/CTIForensicAccountingAcademy.asp>.