



Introduction to Forensic Accounting

ITFA/25/F1

SURGENT 
ACCOUNTING & FINANCIAL
EDUCATION



Objectives for Today's Presentation

- **Objective No. 1: Be informative**
 - Forensic accounting = relevant topic
 - Understand many different aspects of forensic accounting
- **Objective No. 2: Don't be boring**
 - Litigation can be dry
 - Stay relevant



What Will We Cover Today?

- Why you should you consider forensic accounting?
- Types of cases involving forensic accounting
- Litigation support provided by forensic accountants
- Discovering and preventing fraud
- Different types of fraud
- Forensic accounting in bankruptcy proceedings
- Forensic accounting in family law matters
- Financial statement fraud



What Will We Cover Today? (Continued)

- Establishing damages
- Valuation techniques used in forensic accounting
- An introduction to the litigation process
- Working with evidence
- The discovery process



Why Learn About Forensic Accounting?

- The importance of having a **side gig**
 - **Makes you better** at what you do
 - Helps you to understand **legal system**
 - **Compensation** is good
 - Forensic accountants are **experts in their field**



What Is Forensic Accounting?

- Most basic definition: Forensic accounting is the **application of an accountant's skills** to legal proceedings
- What accounting skills are applied?
 - Reviewing and understanding **financial statements**
 - **Converting financial data** into understandable information
 - **Auditing**
 - Making complex **calculations** and projections
 - **Finding fraud!**



What Is the Role of the Forensic Accountant?

- Accounting experts **assist lawyers**, judges, and jurors in understanding and **applying accounting principles to the law** and facts of a case
- Examples of an expert's role:
 - What is the amount of **economic damages**?
 - Was a **fraud** committed?
 - What is the **value** of a business?
 - **Investigate** facts
 - Form **opinions**
 - Serve as **consultants**
 - Most important: **simplify** a complex profession



Necessary Skills of Forensic Accountants

- A Forensic Accountant needs **skills in accounting**
- What type of accounting skills are required?
 - **Business valuation** experts rely on different skills than an expert in **bankruptcy** litigation
 - Forensic accountants in **wrongful death** cases rely on different skills than forensic accountants in **divorce** cases



Necessary Skills of Forensic Accountants

- A forensic accountant needs **skills in auditing**
- Auditing is collecting, interpreting, and **evaluating** data
 - Forensic accountants offer **expert opinions**
 - Opinions offered must be based on **reliable data**
 - Forensic accountant must use **reliable methods** in the collection, evaluation, and calculation of data



Necessary Skills of Forensic Accountants

- A forensic accountant needs **skills in investigation**
 - Know how to properly **conduct an investigation**
 - Understand what **type of evidence** to gather
 - Apply **proper methods** for chain of custody
 - Know how to **identify fraud**



Necessary Skills of Forensic Accountants

- A forensic accountant must know how to navigate **digital forensics**
 - This includes understanding **computer forensics** and **network forensics**
 - Experts help determine what **discovery** is needed
 - Experts help determine what is **contained** within discovery
 - These skills are necessary in both **criminal** and **civil litigation**



Necessary Skills of Forensic Accountants

- A forensic accountant must **understand the legal system**
 - Forensic accountants earn income testifying as **experts at trial**
 - Need to understand **procedures** within legal system
 - Need to understand different **causes of action**
 - Often, a forensic accountant will **specialize** in areas of the law
 - Remember: understanding the legal system is **not difficult**



Litigation Services

- There are three **primary categories** of litigation services
 - Litigation **consultant**
 - **Expert** witness
 - Litigation professional



Forensic Accountant as Litigation Consultant

- A **litigation consultant** is a forensic accountant who is an expert **witness**, but who will not testify at trial
 - Conducts **investigation** and analysis
 - Forms expert **opinions**
 - Writes **reports**
 - **Not disclosed** to other side
 - **Not deposed** and will not testify at trial



Forensic Accountant as Expert Witness

- Forensic accountant conducts **investigation and analysis**
- Formulates **opinions**
- Prepares written **reports** of opinions
- Is **disclosed** as an expert
 - Expert witness sits for **deposition**
 - Expert witness **testifies at trial**



Forensic Accountant as a Litigation Professional

- There are three common “**professional**” **roles** of forensic accountants **outside** of being an expert witness:
 - **Mediation:** the settlement is the “client”
 - **Arbitration:** factfinding
 - **Bankruptcy trustee:** collects and distributes assets of the bankruptcy estate



Primary Role of Forensic Accountant: Expert Witness

- The **majority of work** for forensic accountants is as an expert witness
- Critical skill: expressing expert **opinions at trial**
- Huge distinction between an “**expert**” and a “**lay**” witness
 - Ordinary witnesses typically **cannot offer opinions**
 - Ordinary witnesses testify to **observations**
 - Examples: Did Defendant pay his taxes?
How many employees worked for Defendant?



Primary Role of Forensic Accountant: Expert Witness (Continued)

- You don't want **ordinary people** offering complex opinions at trial
 - Joe is a successful **plumber** who has his GED
 - During his 20 years as a plumber, Joe has had employees leave and **start competing businesses**
 - Joe is **not qualified** to testify as an expert on damages using the income or market approaches in non-compete litigation



Qualifying as an Expert Witness

- Federal Rule of Evidence 702
 - Experts must have **sufficient knowledge, skill, experience**, training, or education
 - Experts may testify in the form of **opinions** or otherwise
 - Testimony should be based on expert's **technical or specialized knowledge**



Admissibility of Expert Testimony

- Expert opinions are **not automatically admitted** at trial
- Attorney must show court **opinions are admissible**
- Requirements for admissibility:
 - **Relevance**: Testimony will help jury understand evidence



Admissibility of Expert Testimony (Continued)

- Requirements for admissibility:
 - Sufficient basis: testimony based on **sufficient facts and data**
 - Reliable: testimony based on **reliable principles** and methods
 - Application: testimony follows proper **application of principles to facts**



Admissibility of Expert Testimony (Continued)

- Example of expert testimony that is **not relevant**:
 - Forensic accountant hired for Plaintiff to calculate damages sustained by a business that **shut down due to hurricane**
 - Forensic accountant testifies that Defendant's **insurance company** earned 18% more **profit** than year before
 - Forensic accountant is qualified to offer opinion, but Defendant's **profits are not relevant** to insurance claim



What Happens if Testimony Is Not Admissible?

- I sue insurance company for **failure to provide coverage** for business loss
- Insurance company hires forensic accountant to offer opinions on **financial loss** sustained by my client
- I take deposition of forensic accountant — demonstrate that **methods** used by forensic accountant are **not widely used**
- I take deposition transcript and attach it to **Motion to Exclude Testimony**



What Happens if Testimony Is Not Admissible? (Continued)

- Insurance company files **Response in Opposition** and Court holds hearing on Motion to Exclude
- I read deposition transcript to Court: used **market value to value a newly formed company**. Uses **weak comps**.
- I **challenge three opinions** and Court agrees to exclude one of three opinions



Establishing a Qualified Forensic Accountant

- Judge is the **gatekeeper**
- Establish **qualifications** for testimony at trial
 - Testified as expert **many times before**
 - **Published materials** relevant to his testimony
 - Has appropriate **education and training**
 - Has relevant **licenses** and certifications



Daubert Challenges

- What is it?
 - Criteria to determine whether expert testimony is **admissible**
- How does it happen?
 - Trial judge serves as **gatekeeper**
 - Determined by **motions** and/or hearings
- What does the Judge decide?
 - Is expert testimony “**relevant to the task at hand**” and does it rest on “a reliable foundation?”
- What must expert show?
 - Conclusions are product of sound “**scientific methodology**”



Daubert Challenges (Continued)

- How do you establish **sound scientific methodology**?
 - Technique **generally accepted** in scientific community
 - Technique has been subjected to **peer review** and publication
 - Technique/opinion has been **tested**
 - **Rate of error** is acceptable
 - **Research** conducted independent of litigation



Is the Forensic Accountant's Method Reliable?

- Forensic accountant forms an opinion **solely for this case**
- **Example:** F.A. previously testified to a **valuation** methodology for a **tech start-up company**
 - F.A. later uses his **same valuation** methodology to provide opinion on the value of a **salvage business** in a divorce case
 - Q: Can you **name one instance** where this methodology has been used to value a company other than a tech startup?



Basis for Expert Opinion: FRE 703

FRE 703:

An expert may base an **opinion on facts or data in the case** that the expert has been made aware of or personally observed. If experts in the particular field would **reasonably rely on those kinds of facts** or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted ...



Hearsay Evidence

- Rule 703 allows experts to **rely on hearsay** to form opinions
 - Forensic accountants **interview people**
 - Forensic accountants can cite statements (**hearsay**) in order to support their opinions
 - Forensic accountants can cite **hearsay documents**



Conclusory Statements

- Forensic accountants can offer **opinions on the ultimate issue** in a case
 - Forensic accountant testifies in **bankruptcy case**
 - **Creditor** argues company is **not insolvent**
 - Forensic accountant can testify company is **not insolvent**
 - This opinion goes to **ultimate issue** in case - solvency



Presenting the Opinions of the Expert

- Expert opinions that do not contain a **sufficient degree of certainty** may be **inadmissible**
- Inadmissible expert opinions:
 - **Speculation:** based on a **possibility**, not certainty
 - **Vague:** cannot say facts “tend to suggest”
- It is okay if a forensic accountant **provides a range of estimates**



Rule 26 Expert Reports

- Rule 26 requires the disclosure of expert reports
Complete statement of **all opinions**
 - **Basis** for all opinions
 - Facts and data **considered** by the witness
 - Any **exhibits** the witness will use
 - The witness's **qualifications**
 - **Publications** in last 10 years
 - **Cases** in last four years where they testified as an expert
 - Statement of **compensation paid**



Beware of Expert Reports Being Excluded

- Reasons why **expert reports** are **excluded by courts**
 - Qualifications **omitted**: must list publications for the last 10 years
 - Conclusory: report **lacks sufficient factual basis**
 - Vague: facts relied upon **lack specificity** (witnesses or documents not identified)



Using Expert Reports During Deposition

- Expert reports **summarize expert's opinions**
- Use them to **guide experts** through your deposition
- Answer these questions:
 - What are your **opinions**?
 - What **information did you use** to reach your opinions?
 - What **methodology** did you follow?
 - Why is that methodology **reliable**?
 - What information do you need **to form future opinions**?



Opposing Counsel's Objectives During an Expert's Deposition

- **Understand** expert opinions: ask detailed questions regarding each opinion
- **Challenge** qualifications: show jury lack of experience
- **Lock in** opinions: any other work needed?
- **Evaluate** demeanor: is expert articulate & empathetic?
- **Develop** cross-examination: find best questions to ask at trial



Types of Cases Where You Can Serve as an Expert

- Expert testimony is a **growth industry**:
 - Bankruptcy
 - Business interruption
 - Breach of contract
 - Divorce/family
 - Fraud
 - Lender liability
 - Wrongful death
 - Unfair trade practices & fraud
 - Tax cases (estate, property, income, and gift)



Forensic Accounting and Fraud

- Forensic accountants are well suited to **identify and deter fraud** in an organization
- What is a good **definition of fraud**?

Fraud is an **intentional act or omission** that is designed to deceive and results in a **loss to the victim** and a gain to the perpetrator



How Do Companies Manage Fraud?

- Fraud is one of **many types of risk** that organizations must manage
- Ways companies **manage fraud**:
 - **Corporate governance** structures
 - Fraud risk **assessments**
 - Fraud **prevention** procedures
 - Fraud **detection**
 - Fraud **investigation**



The Role of the Board of Directors When Managing Fraud

- **Board of directors** plays a critical role in managing fraud
 - Create/implement **business ethics** program
 - Understand **fraud risks**
 - Oversight of fraud risk **assessment**
 - **Monitor management** and its handling of fraud
 - **Audit** internal fraud controls
 - Set appropriate **tone**
 - Retain and manage **outside experts**



Role of Audit Committee in Managing Fraud

- Boards often create **audit committees** to handle fraud risk management
 - Committee should be **independent** board members
 - Committee should have an **accountant**
 - Committee works with external **auditors and legal counsel**



Role of Management in Controlling Fraud

- **Management** plays a critical role in controlling fraud:
 - Understand and identify **signs of fraud**
 - Understand and implement **internal controls**
 - Help create a strong **environment that reduces fraud**
 - Participate in **monitoring** for fraud
 - Report **suspicious or fraudulent activity** to the board
 - **Cooperate** with investigations



The Role of the Internal Auditor in Managing Fraud

- An **internal auditor** provides independent evaluations of fraud:
 - **Advise the board** on whether sufficient fraud controls are in place
 - **Monitor whistleblower claims** and processes for reporting fraud
 - Conduct **ethics training**
 - Establish and maintain a **code of conduct**



How Fraud Risk Assessment Reduces Fraud

- **Fraud risk assessments** can help prevent fraud before it starts
- **Three components** to a fraud risk assessment:
 - **Identify risks** of fraud within an organization
 - **Assess likelihood** or significance of each fraud risk
 - **Respond** to likely and significant fraud risks



Factors To Consider in Fraud Risk Assessment

- Questions a forensic accountant should consider when preparing a **fraud risk assessment**:
 - What is the organization's past **history of fraud**?
 - What is the incidence rate of **fraud within industry**?
 - What is the risk of fraud **within individual departments**?
 - What is the **complexity and size** of the organization?
- For each factor, is the risk **remote, possible, or probable**?



Fraud Prevention

- Prevention is the **most effective way** of controlling fraud
- **Benefits** of prevention:
 - Build **barriers** to fraud
 - Build **deterrence** to fraud
 - **Prevent** expensive investigations



Fraud Prevention Controls

- Human resource procedures can help **control fraud**:
 - Job applicant **background investigations** (ex. depo prep)
 - **Training employees** on identifying and preventing fraud
 - **Employee evaluation** programs
 - Authority **limits**
- Fraud prevention programs must be **well documented**



Fraud Detection

- Assume that fraud **cannot be fully prevented**
- If it cannot be eliminated, organizations **need detection** systems
 - Need to detect fraud **as it occurs**
 - Example of good fraud detection: **whistleblower hotline**



Whistleblower Hotline

- A whistleblower hotline can be one of the **most effective ways** to detect fraud
 - Also very **cost effective**
- **Best practices** for a whistleblower hotline:
 - **Promote** hotline (educate everyone)
 - Provide **anonymity** to whistleblowers
 - Provide reporting to **senior management**



What Factors Contribute to Fraud?

- Fraud often arises from the existence of one or more components:
 - **Internal pressure** (i.e. gambling, excessive lifestyle, medical bills)
 - **External pressure** (i.e. meet targets, hide poor performance)
 - **Opportunity** (company trusts employee — provides authority)
 - **Rationalization** (fraudster creates an excuse to commit fraud)



Example of Corporate Fraud

- Large **construction company**
- **Project director** - very successful; set up a shell company
 - Sister ran the shell company
 - Submitted **bogus invoices** and authorized payment
- Two-year, multimillion dollar fraud
- Fraudster eventually **got caught**
 - New home, new car, new boat and new wife
- Whistleblower hotline — **anonymous tip**
 - Hire attorney to **prove fraud** and collect money (send a message)



Example of Corporate Fraud (Continued)

- Take everyone's **deposition** (sister, co-workers, ex-wife, new wife)
- Depose the fraudster ... and **he confesses**
- Why did he commit fraud?
 - Believed company exceeded **profit targets**
 - Believed stealing excess profit was **justified**
 - Thought he was dealing with **play money** that he created
- Never determined whistleblower



Creating Fraud Risk Management Systems

- First ask what is the company's **tolerance for risk**
 - Tolerance for risk affects **design of fraud risk management**
 - **Balance cost** of fraud prevention against fraud losses
- Components of fraud management:
 - **Prevention** (whistleblower hotline)
 - **Detection** (reviews/audits)
 - **Investigation** (hiring outside counsel)
 - **Correction** (revise controls)



Using Fraud Indicators

- Fraud risk management **relies on indicators**
 - **Single factor** indicators (i.e. red flags)
 - **Composite fraud** indicators (i.e. formulas)
 - **Random** indicator (i.e. unannounced audit)
 - **Pattern-based** indicator (i.e. spotting abnormal activity)



Forensic Accounting and Fraud Schemes

- Forensic accountants are **fraud investigators**
- Investigation requires ability to **identify fraud schemes**:
 - **Internal** fraud
 - **External** fraud
 - Frauds against **individuals**



Internal Frauds

- **Internal fraud** arises when an **employee** commits a fraud on an employer
 - **Corruption:** an employee **fails to act** in the company's best interest
 - **Misappropriation:** taking **company property** for personal use
 - **Financial statement fraud:** intentional **misrepresentations**



External Frauds

- External frauds occur when a non-employee commits a **fraud against an organization**
 - Fraud can be committed by **customers, vendors, or strangers**
 - Example: a vendor knowingly sells a company **substandard products**



Individual Frauds

- Individual frauds are directed **toward individuals**, not organizations
- Examples of individual frauds:
 - **Ponzi schemes**
 - Email **phishing** schemes
 - **Identity theft**



Employee Fraud: Corruption

- Two of the most common employee corruption schemes involve **bid rigging and kickbacks**
- Three ways to rig a bid:
 - Bid **suppression**: reward for withholding bids
 - **Complimentary** bids: fake bids that are excessively high
 - Bid **rotation**: vendors agree to alternate seeking winning bids



Employee Fraud: Asset Misappropriation

- There are four common types of **misappropriation schemes**:
 - **Revenue cycle** (i.e. skimming cash receipts)
 - **Lapping** (i.e. accounts receivable fraud)
 - **Improper credits** (i.e. refunds to friends and family)
 - **Improper write-offs** (i.e. unauthorized write-offs)



Expenditure Cycle Fraud

- Expenditure fraud is fraud **involving cash payments**
- There are **two main categories** of expenditure fraud:
 - **Improper purchases**
 - **Payroll fraud**
- Expenditure fraud often involves **front companies**



Expenditure Fraud: Improper Purchases

- **Improper purchases:** a purchase is not made according to company policies
 - Often involves **collusion** and management overrides
- How to reduce fraud? **Voucher programs** are an option
 - Purchase requisition
 - Purchase order
 - Receiving report
 - Vendor's invoice



Expenditure Fraud: Payroll Fraud

- Payroll fraud: this involves **theft of cash through the payroll processing system**
- Involves **improper hiring**, improper changes to employee files, and improper reporting of employee activities
- **Improper hiring:** hiring employees **without proper review**
- Improper **changes to employee files:** fraudulent raises, promotions



Production Cycle Fraud Defined

- Production cycle fraud involves **theft of raw materials** and finished goods
- **Theft of inventory** is the main form of production fraud
- How does it happen?
- Person responsible for inventory management also has **access to accounting records**



Production Cycle Fraud Prevention

- Easiest way to **reduce production cycle fraud** is through physical security and accounting controls
 - **Track raw materials** to work orders
 - **Track finished goods** via job orders and production schedules
 - **Perform reconciliations** and count goods



Types of Production Cycle Fraud

- Production frauds often occur when **accounting for waste, scrap, and spoiled goods**
 - Example: Employees discard “spoiled” goods that are **not actually spoiled**
 - Example: **Intentionally over-ordering** for a job may intentionally create waste or “spoiled” goods



Fraud Through Electronic Systems

- **Input manipulation:** Fraud when **entering data** into a company's computers
- **Direct file alteration:** Employee **bypasses** the normal accounting system
- **Data theft:** Copies important data and **uses the data** for personal use
- **Sabotage:** **Intentional harm** to networks



Vendor Frauds

- **Short shipments:** Vendor **ships incomplete orders** and bills for a complete order
- **Balance billing:** Vendor bills company for the balance, **but fails to credit** for returned goods or overcharges
- **Substandard goods:** Company incorporates **poor quality goods** into its final products



Vendor Frauds (Continued)

- The best way to combat vendor fraud is through a **strong purchasing protocol**
- Collusion between **company inspector and vendor** is always a risk
 - **Segregate duties** (person who receives goods vs. paying)
 - **Review vendor accounts** (investigate payments to P.O. Box)



Identity Theft Fraud

- **Identity thefts grow** in number and complexity:

Driver's license theft:

most common form of identity theft

Social Security Number:

occurs with **data breaches**

Account takeover:

occurs with **malware & phishing** scams

Tax identity theft:

filing a **fake return** in your name

Biometric ID theft:

fingerprint and voice recognition stolen



Fair and Accurate Credit Transaction Act of 2003

- Intended to **protect consumers** and reduce identity theft:
 - Only **last five digits of credit card numbers** can appear on statements
 - Companies must have **systems to detect** and prevent identity theft
 - Businesses must **provide notifications** to victims and credit bureaus



Types of Identity Thieves

- **Hackers & phishers:** use the internet to **steal identity**
- **Insiders:** companies that **provide credit** have employees with access to identity information
- **Trash:** companies with **poor document disposal** practices



Investigating Identity Theft

- It is very difficult to catch identity thieves
 - 44% of **violent crime** suspects are arrested
 - 16% of **property crime** suspects are arrested
 - .14% of **identity theft** suspects are arrested (2006 study)

- Why?

Many suspects **live outside** the U.S.
Arresting identity thieves **lower priority** compared to violent criminals



Investigating Identity Theft: Controlled Delivery

- **Controlled delivery** is one method law enforcement uses to find identity thieves
- This involves catching thief at a **physical location**:
 - **Thief at bank** to withdraw cash
 - Go to a mail center
 - ***Purpose is to **trick fraudster to appear** in person***



Money Laundering Fraud Schemes

- Money laundering: placing **illegally obtained funds** into the financial system
- Purpose is to make it look like **illegal funds** came from a **legitimate source**
 - Example: Breaking Bad - Walt has millions in drug money; **buys car wash** to run cash through business



Money Laundering: Three-step Process

There is a **three-step process** to money laundering:

- **Placement:** Deposit money into a financial institution
- **Layering:** Move money from one account to another
- **Integration:** Make funds use by money launderer



Money Laundering: Avoiding Detection

Three common ways **money launderers avoid detection**:

- **Smurfing:** Limiting bank deposits to under \$10,000
- **Front business:** Build a legitimate business to run cash through
- **Corrupt bank:** Launderers buy a bank or bribe bank officials (usually in countries with high corruption)



Bankruptcy Fraud

- **Bankruptcy is a legal framework** that creates “bankruptcy estates” used to discharge or reorganize debts
 - Bankruptcy proceedings are governed by **Title 11** of the United States Code
 - **Federal Rules of Bankruptcy Procedure** govern the bankruptcy process



Why Learn About Bankruptcy?

- Forensic accountants can **play several important roles** in a bankruptcy proceeding:
 - Bankruptcy **trustee**
 - Expert to **investigate fraud**
 - Expert to determine whether the **debtor is insolvent**
 - Expert for the recovery of **avoidable preferences**



The Different Types of Bankruptcy Proceedings

- Chp. 7: Allows for the **liquidation of all assets** and elimination of all debts
- Chp. 9: Bankruptcy for **municipalities**
- Chp. 11: Debtors are **reorganized**; assets are not fully liquidated
- Chp. 12: Bankruptcy for **farming and fishing** companies
- Chp. 13: Bankruptcy for **individuals with too much income** for Chp. 7
- Chp. 15: Bankruptcy proceedings for **parties outside the U.S.**



Seeking Dismissal of a Bankruptcy Proceeding

- **Creditors lose money** (lots of money) when a debtor files for bankruptcy
 - Imagine having a **\$160,000 invoice for goods sold** to a debtor that is completely discharged through bankruptcy
- Creditors and bankruptcy trustees can seek to have the entire **bankruptcy case thrown out** (i.e. dismissed)



Forensic Accountant and Bankruptcy

- People and companies regularly **abuse the bankruptcy process**
- Forensic accountants help **determine if a debtor is really insolvent**:
 - Review the debtor's **books and records**
 - Compare **assets against liabilities**
 - **Question debtor** regarding pre-bankruptcy transfers
- Forensic accountants **find abusive bankruptcy filings**



How To Discover Bankruptcy Fraud?

- Rule 2004 Examination: Federal Rule of Bankruptcy 2004 allows a bankruptcy trustee to **conduct broad discovery** of the debtor
 - Forensic accountants, working for the trustee, can **request the production of documents** from the debtor
 - Forensic accountants can **compel testimony** under oath



What Is Bankruptcy Fraud?

- **Bankruptcy fraud** occurs when a person or entity **knowingly commits** any of the following:
 - **Conceals property** from the bankruptcy proceedings
 - Intentionally makes a **false oath or accounting**
 - Files a **false proof of claim**
 - Hides, destroys, or **falsifies documents**
- There are **many other forms** of bankruptcy fraud



Start With the Debtor's Financial Statements

- Schedule A: Real property
- Schedule B: Personal property
- Schedule C: Exempt property
- Schedule D: Secured claims
- Schedule E: Unsecured priority claims
- Schedule F: Unsecured nonpriority claims
- Schedule G: Contracts and leases
- Schedule H: Co-debtors
- Schedule I: Current income
- Schedule J: Current expenditures
- Statement of Financial Affairs



Reviewing the Debtor's Bank Statements

- Compare bank **statements to debtor's schedules**
 - Look to see whether balances match assets listed by debtor
- Compare **brokerage statements** to debtor's tax returns
 - Has debtor listed all sources of income?
- **Examine transfers** in and out of accounts
 - Have all accounts been disclosed?



Using a Debtor's Tax Returns in Bankruptcy

- Tax returns are a **great place to find assets** concealed by a debtor
 - Form 1040 Schedule B: **interest and dividend income**
 - Form 1040 Schedule E: **income from rental properties, trusts**
 - Form 1040 Schedule D: **disposition of assets**
- W2: Look for **contributions to a retirement account**



Using a Debtor's Loan Applications

- Loan applications are an **excellent source of information** regarding a debtor's assets
 - Loan applicants **disclose as many assets as possible** to increase their chances for approval
 - Forensic accountant should ask the debtor under oath about **all loans applied** for in the last five years
 - Forensic accountant should seek loan **records directly from the lender**



Investigation Tactics for Corporate Bankruptcy

- Examine deposits
 - **Confirm all collections** were deposited
- Review accounts payable
 - Confirm payables made to **real vendors**
 - Confirm payments were for **legitimate purposes**
- Review debtor's correspondence
 - Identify **correspondence with banks** regarding accounts



Investigation Tactics for Corporate Bankruptcy

- **Payments to managers** or owners
 - Were payments made in the **ordinary course of business**?
 - Were payments at **fair market value**?
- Review the debtor's assets
 - Conduct detailed analysis to **confirm all assets**
 - Identify **intangible assets** (may not be on balance sheet)



Forensic Accounting and Family Law

- Divorce often involves the **distribution of assets**
 - Need to know what the **value of assets**
 - After assets are valued, **court can distribute**
 - Determine how to distribute assets **while protecting value**



Forensic Accounting Services in Family Law

- **Identify** assets, liabilities, and incomes
- **Value** of assets, liabilities, and income
- **Division** of assets, liabilities, and income
- Trace assets to determine origin and **whether they are marital assets**
- Help determine what is an **equitable distribution** of assets
- Address **tax effects** of transactions and distributions
- Determine an **income of a spouse** and financial standard of living



Family Law as a Point of Entry for Forensic Accounting

- Family law may be one of the **easiest ways to begin** as a forensic accountant
 - It is easy to **locate and network** with family lawyers
 - Opinions offered in divorce cases often **mirror tax and financial planning** opinions
 - Forensic accountants can **offer competitive rates** to gain litigation experience



From Consultant to Expert Witness

- Husband and wife **own a distribution business**
 - Combined net worth: \$2.2 million
 - Couple had a successful marriage for 25 years
 - Seek an amicable divorce
- Wife's attorney retains forensic account to **value assets**
 - F.A. acts as consultant and reviews books and records
 - Attorney presents settlement proposal based on valuation
 - Husband concludes business highly overvalued



An Introduction to Divorce Proceedings

- **Commencement:** A divorce begins when one spouse files a petition or complaint
 - The other spouse is served with the complaint
 - Served spouse must file a responsive pleading (i.e. an answer)
 - Complaint spells out grounds for divorce
- **Discovery:** Gather facts from your opponent much like in traditional litigation
 - Forensic accountant can help in identifying information needed from opponent



An Introduction to Divorce Proceedings (Continued)

- **Financial affidavits**
 - Many states require each spouse to complete and sign a financial affidavit
 - **Affidavit:** swear under oath that its contents are **true and correct**
- Affidavits are important - provide **highly relevant information**:
 - Assets
 - Liabilities (Forensic accountant can review all information)
 - Income
 - Expenses



An Introduction to Divorce Proceedings (Continued)

- Categories of property:
 - Florida Statute 61.075 establishes the **process of distributing property** between spouses
 - Court must **first classify property** as marital and nonmarital
 - This is important distinction: Court distributes marital assets
 - Nonmarital property is kept by each spouse who owns it
- Valuation of property:
 - Once Court values assets, it can **equitably distribute assets**
 - Court assumes property will be **distributed equally**



Marital vs. Nonmarital Property

- Florida's **definition** of marital property:
 - "Assets acquired and liabilities **incurred during the marriage** individually by either spouse or jointly by them"
 - In Florida, **professional goodwill** developed during the marriage can be a marital asset
 - The **forensic accountant** for either spouse can **assist in placing a value** on professional goodwill
 - The Court **ultimately decides** the value of goodwill



Financial Statement Fraud

- Financial statement fraud consists of **misrepresentations** in:
 - Financial position
 - Results of operations
 - Cash flows
- Forensic accountants are retained to determine whether financial statements are **accurate**
 - This work **overlaps** with the work of auditors



Role of Forensic Accountant and Financial Statement Fraud

- Forensic accountants are asked to **review financial statements** for two primary reasons:
 - Suspicion that **fraud** was committed in **preparing statements**; or
 - Concerns about **losses** in financial statements are **incorrect**
- Big picture: Financial statement fraud is the **inclusion or exclusion of information** that causes the statement to misrepresent the company's finances



Intentional Misrepresentations

- Financial statements may contain **misrepresentations due to honest mistake** and intentional misrepresentations
 - Forensic Accountants determine whether **misstatements were intentional**
- **Intentional misrepresentation** = fraud
 - Example: Husband in a divorce **intentionally undervalues** his business
 - Forensic accountant can **testify to the fraud** she discovered
 - Court can **sanction spouse** who committed fraud



Negligence Versus Fraud

- Forensic accountants often **testify regarding their findings**
 - Testify in **depositions and at trial** regarding the conduct of others
 - Need to understand difference between **negligence and fraud**
- Negligence is failing to act with a reasonable level of care
 - **Incorrectly entering data** onto a financial statement is **negligence**
 - Negligence means someone has a **duty** and breaches their duty



Negligence Versus Fraud (Continued)

- Gross negligence is a **reckless disregard** of a duty owed
 - Having an **inexperienced receptionist** prepare a financial statement of a publicly held company may be **gross negligence**
- Fraud occurs when items on a financial statement are **intentionally misrepresented**
 - This includes **intentional omission**



Earnings Management vs. Fraud

- Financial reporting standards allow companies to **use discretion** in accounting for transactions
- Management has **flexibility** by engaging in **earnings management**
- Example: Company worries that it might **not meet expectations** with earnings
 - Company may **sell assets** to increase earnings
 - Company may **lower estimate** of contingent liability



Methods of Financial Statement Fraud

- There are three general categories of **financial statement fraud**:
 - **Improperly accounting** for transactions
 - Recording **fictitious transactions**
 - **Falsifying** financial statements
- Improperly accounting for transactions
 - Example: Recording an expense as an asset
- Recording fictitious transactions
 - Example: Recording transactions that did not occur



Methods of Financial Statement Fraud (Continued)

- Improper **revenue recognition**
 - This involves **recognizing greater revenue than allowed** by accepted accounting principles
 - Results in **overstatement of assets**
- **Sham sales:** appear on the records; however, they never occurred
 - Example: Buyer & seller agree buyer will return asset after balance sheet date
 - Example: Sales transaction entered solely to mislead
 - Example: No sales transaction occurred, but one was recorded in books



Detecting Sham Sales

- Sham sales are often recorded **near end of the fiscal year**
 - Management determines it needs to report additional income to **meet expectations**
 - Forensic Accountant can **examine overdue accounts receivables** and write-offs
 - Examine method in which year end sales were recorded
 - Examine when sales were recorded



Premature Revenue Recognition

- This is the recognition of revenue **before it is earned**
- Premature recognition **overstates revenue** by recognizing revenue from a future period
- **Future revenue becomes understated** and creates pressure to increase future revenue
 - This can cause future fraud



Damages

- People and companies commence legal actions to **receive relief** through the court system
- There are many **different kinds of relief** you can receive:
 - **Equitable relief**
 - **Economic damages**
- Equitable relief is **not money**
 - Ask Court to enter an **injunction**
 - Injunction: Court orders someone to do something or not do something



Economic Damages

- Economic damages: placing a **dollar amount on harm** done
- Economic damages arise in **many different contexts**
 - **Breach of contract**
 - Negligence
- Breach of contract damages
 - What was the **financial harm sustained** by the plaintiff because of the defendant's breach of the contract?
 - Forensic Accountants help **build or defeat** the damages claim



Negligence Damages

- Negligence damages consist of financial harm caused by the Defendant's **breach of the duty of care**
 - You owe me and everyone else a **duty to drive safely**
 - If you cause an accident from reckless driving, you have **breached that duty**
- **No damages = no claim**
 - Rear-end motor vehicle **collision**
 - Driver was **texting** while driving
 - Driver in front vehicle has **no injuries/no damages** to vehicle
 - Forensic Accountant can only build damages **where damages exist**



Negligence Damages (Continued)

- Same rear-end collision but with **severe damages**
 - Car is **totaled** and Plaintiff sustains a **fractured neck**
 - Plaintiff **loses job** as charter boat captain
 - Can work desk job, but **lacks skills** to earn same salary
- Plaintiff's attorney hires a forensic accountant and vocational rehabilitation expert
 - Looks at **income history**
 - Looks at **life expectancy**
 - Looks at **discount rate** to calculate net **present value** of lost wage claim



Causation

- To prove someone is at fault, you must **prove liability**
 - Liability means someone is **at fault**
 - You have to **prove liability and damages**
 - Forensic Accountant can establish **causation and damages**
- Example of forensic accountant establishing causation
 - Company hires forensic accountant for **claim against former vice president**
 - Vice president quit and started a **competing business**
 - Company sues vice president for **lost sales, claiming tortious interference with a business contract**



Causation (Continued)

- Vice president testifies that losses were **due to lack of demand** and bad sales
 - Forensic accountant investigates and **testifies on causation**
 - Demand did not drop
 - Vice president called on **15 biggest clients** and 7 left
 - Vice president **caused company to lose sales**
- Forensic accountant has testified on **liability and damages**



Compensatory Damages

- Compensatory damages are intended to put the Plaintiff **back to where she was** before the loss
 - Often described as “**making Plaintiff whole**”
- Examples of compensatory damages:
 - **Lost wages**
 - **Out-of-pocket expenses**
 - **Lost profits**
 - **Lost value**



Items Relied Upon by the Forensic Accountant

- To form opinions on damages, the forensic accountant considers several things:
 - **Documents:** Historical financial information, tax returns, bank statements
 - **Testimony:** Rebutting expert opinions, testimony regarding prior sales or income vs. current sales or income
 - **Treatises:** Research showing opinions are based upon reliable methodologies (remember Daubert)
 - **Publications:** Government studies, mortality tables, average retirement ages, etc.



“But for” Method for Damages

- What were the company’s damages **after the breach of contract**?
- What would damages have been **“but for” the breach**?
- The **difference in sales** is the company’s damages
 - **Because of the breach**, company had \$500,000 in annual sales
 - But for the breach of the non-compete agreement, company **would have earned \$850,000** in annual sales
 - **Damages = \$350,000**
 - Damages may include **attorney’s fees, cost, and interest**



Punitive Damages

- In Florida state courts, a Plaintiff **cannot seek punitive damages** without court approval (Plaintiff must allege sufficient facts)
- Punitive damages are intended to **punish the wrongdoer**
- The amount of punitive damages may depend on the **wrongdoer’s net worth**
 - Goal of punitive damages: inflict pain on wrongdoer **without putting them out of business**
 - Forensic accountant can assist in preparing, responding to, or **analyzing net worth discovery** for punitive damages



Lost Profits

- **Lost profits** are often used to calculate damages in **business litigation**
- Step 1: Show the company's **profits before it suffered** product disparagement
- Step 2: Next show the company's **profits while competitor is making false claims**
- Step 3: Finally, show profits **once company recovers** from disparagement
- **Profits lost due to product disparagement** are the company's damages



Forensic Accountant's Calculation of Damages

- Forensic accountant must make sure **his method for calculating damages is sound**
 - Remember *Daubert* challenges where opponent argues **opinions are not reliable**
- The forensic accountant decides to use **income vs. cash method**
 - One method **relies on cash flow** to calculate losses
 - One method **relies on accounting income** to determine losses



Damages Timeframe

- Damages begin at **time harm is sustained**
- Determining **when damages end** can get complicated
- Example: Loss of income in a negligence action is based off of **average retirement agent**
 - Defense forensic accountant testifies Plaintiff (a plumber) will **retire at age 58** because being a plumber is physically demanding
 - Problem: Defense forensic accountant also testified that Plaintiff was living “**paycheck to paycheck**”
 - **Jury agrees with Plaintiff’s forensic accountant** - loss of income claim calculated to age 67, not age 58



Valuation

- Business valuation involves **placing an economic value on:**
 - Businesses
 - Ownership interests
 - Collateral
 - Intangible assets
- Valuation concerns determining what **value the market will place on asset**
 - Valuation = market’s assessment of what something is worth
 - Markets change and asset prices change as well



Present Value

- Present value measures the **worth of a future amount of money** or stream of payments in **today's dollars adjusted** for interest and inflation
 - Present value compares the buying power of one future dollar to the purchasing power of a dollar today
- Theory - we **prefer to have things now** versus in the future
- Present value is the **current value of a future sum** of money
 - Value of expected income stream **determined at the date of valuation**



The Fundamentals of Litigation

- Litigation continues to grow **more complex**
 - **New laws**, regulations, and industries
 - **More parties** file lawsuits
 - Lawsuits **grow in size** (dollar amount & complexity)
- This all creates **more demand** for forensic accountants
 - Employee fraud
 - Financial statement fraud
 - Non-compete litigation
 - Whistleblowers
 - Wire fraud



Investigating Fraud at a Company

- **Example:** Fraud occurs at a company and an **investigation follows**
 - Forensic Accountant works **with management and attorneys**
 - Investigate and **assess the fraud**
- **Role of forensic accountant**
 - Review financial records, bank statements, etc.
 - Helps identify the **badges of fraud**



Proving Fraud

- Proving fraud requires **showing intent**
 - Intent often cannot be proven with **direct evidence**
 - Lawyers must rely on **circumstantial evidence**
- Circumstantial evidence **relies on inference**
 - Example: Fingerprints tell you person was at crime scene
Placing someone at crime scene = infer he committed crime



Badges of Fraud: Fraudulent Transfers

- Fraudulent transfer: **Transfer of property** to a third party with the intent to hinder, delay, or **defraud a creditor**
- **Factors** a judge will consider:
 - Transfer asset to **an insider**
 - Debtor **retained control** of the transferred property
 - Transfer was **concealed**
 - Debtor sued **before transfer made**
- These factors provide **circumstantial evidence of fraud**



Understanding the Legal Process

- Complaint: **Begins** the legal action; states the **facts and legal basis** for the claim
- Jurisdiction: Are you in the **right court?**

Example: Bankruptcy = federal Divorce = state

- Responsive Pleading: **Answer to Complaint** or Motion to Dismiss
- Pleading Fraud: **Federal Rules** requires particularity



Discovery: Request To Produce

- Discovery allows the parties to **assess the strengths and weaknesses** of their case
- Request to produce: **obtain documents** from your opponent
 - Bank statements
 - Emails
 - Training manuals
 - Contracts
 - Employee files
- Request must be **relevant or likely to lead** to the discovery of relevant information



Discovery: Interrogatories and Depositions

- Interrogatories: Ask **written questions** and get **verified answers** sworn under oath as true
- Depositions: Ask questions **in person**, under oath
 - **Gather all relevant documents** through a Request to Produce or Subpoena
 - Find out what **they will say at trial**
 - Let the witness **educate you** on facts you do not know
 - Assess **credibility**



Motion Practice

- Motions are how you get the Court to **take action**
- Want to prohibit **Defendant's expert** from testifying?
 - File a Motion to Exclude Expert Opinions
- Defendants won't give you relevant documents?
 - File a Motion to Compel Production of Documents



Trial

- Trial is where all the **work comes together**
- **Voir dire:** picking a jury
- **Opening statements:** introducing the jury
- **Case in chief:** forensic accountant testifies
- **Closing arguments:** explain to the jury how evidence supports your case
- **Verdict:** Jury renders a decision



Final Thoughts

- **Keep reading** and studying topics in forensic accounting!
- **Excellent reference** for materials addressed today:

Essentials of Forensic Accounting, First Edition.
2015 American Institute of Certified Public Accountants

Thank You!
