

National Litigation Consultants' Review

August 2009

Volume 9

Issue 2

Information, guidance, and resources from the nation's leading testifying, financial experts.

UPCOMING

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BY for the General Practitioner
November 2, 2009, Harrisburg, PA

P. Dermot O'Neill
PICPA Business Valuation Conference
Valuation Case Update
November 2, 2009, Harrisburg, PA

FEATURE ARTICLE

Fraud and Forensics Goulash¹

BY LARI B. MASTEN, MSA, CPA, ABU, CVA

Financial scandals in the last decade have launched the term "Forensic Accounting" to celebrity status as a buzzword in our industry. Academic circles are grappling with how to modify their curriculum to keep up with Generally Accepted Accounting Principles (GAAP) financial reporting standards as well as the International Financial Reporting Standards (IFRS)², as the number of students majoring in accounting and finance is skyrocketing. There is a direct correlation between the legal battles that surround events such as Enron's special purpose entity (SPE) manipulations and AIG's demise, and enrollment in financial and fraud based curriculum.

The number of accounting graduates reached a record level during the 2007-08 academic year, according to the AICPA's *2009 Trends in the Supply of Accounting Graduates and the Demand for Public Accounting Recruits*. More than 66,000 combined bachelor's and master's degrees were awarded, a 3.5% increase from 2006-07, and the highest number since 1972, when the AICPA began tracking this data (emphasis added)³.

Spurred by increased demand for forensic accountants and financial experts, this increase in enrollment is not surprising when

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I SOLEMNLY SWEAR

Murphy's Law as it Applies to Litigation

BY CHARLES S. LUNDEN, CPA/ABU/CFF, CFE, CLU, FLMI, AND CMA

In 1952, author Anne Roe published the following quote:

"There is, for example, the physicist who introduced me to one of my favorite "laws," which he described as "Murphy's law or the fourth law of thermodynamics" (actually there were only three last I heard) which states: "If anything can go wrong, it will"."

This adage is custom-made for the litigation process.

In 1998 I faced my first motion in limine to strike an expert opinion. Murphy's law was in full force and effect. The hearing occurred at the worst possible time,

without notice, under difficult circumstances, for which I was not prepared. Somehow, justice prevailed.

Case Background

In 1995 I prepared an expert report on damages on behalf of a plaintiff in a breach of an oral contract dispute. The plaintiff was a small business, with one key executive. The defendant, a Fortune 500 manufacturer, argued that there was no dispute worthy of a jury trial, and convinced the judge to dismiss the case during summary judgment arguments. The plaintiff's counsel appealed, and some months later, the appeals court remanded the

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PUBLISHER

Litigation Forensics Board of NACVA

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The *National Litigation Consultants' Review* (NLCR) is published online 12 times a year by the Litigation Forensics Board of the National Association of Certified Valuation Analysts (NACVA), 1111 Brickyard Road, Suite 200, Salt Lake City, Utah 84106-5401, sponsors of the Certified Forensic Financial Analyst (CFFA) designation. NLCR is free to holders of the CFFA designation, complimentary for attorneys, \$95 a year for KeyValueData (KVD) subscribers, and retails for \$195 a year. Address subscription requests to NACVA's Director of Member Services (nacval@nacva.com) and other correspondence to the Managing Editor at the above address.

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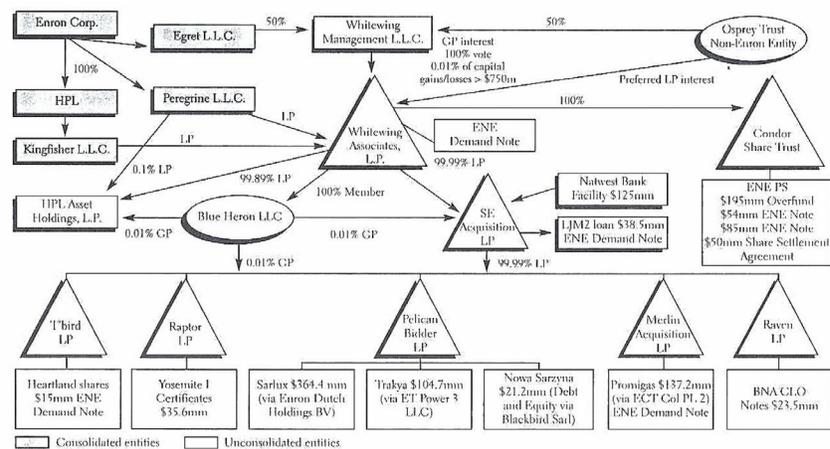
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you consider the schemes hatched right under the very noses of auditors. As an example – let us recall a benchmark case: Enron, which used hundreds of special purpose entities to remove huge debt levels from its balance sheet. The company represented to investors that it hedged downside risk in its own illiquid investments through transactions with special purpose entities, yet investors were unaware that the special purpose entities were actually using Enron's own stock and financial guarantees to carry out these hedges - Enron was, in fact, NOT protected from the downside risk.

The relationship summary alone of Whitewing Associates, one of Enron's hundreds of special purpose entities, is five pages long⁴.

Take a moment to look at the Whitewing Associates relationship chart below⁵:



In looking at the complexity of fractional ownership and subordinated debt in this chart, there is no doubt of the need for competent and dedicated financial experts who can provide clear guidance to the public, in light of the legality of such structuring. These experts would come presumably in the form of 'Forensic Accountants' or 'Fraud Examiners'.

What is curious professionally is the fact that nobody really seems to agree on the definition of 'Forensic Accounting' or 'Financial Forensics', and there is a tendency to simply toss in the word 'Fraud' when using or describing either term.

Even more curious was the statement overheard recently that, "Financial experts in the United States just do not get the difference between fraud, forensic accounting, and financial forensics. Everyone outside the US gets it, but we just don't, and we're supposed to be the experts!"

I have often heard the terms used interchangeably by attorneys, clients, and peers, however, I have never really given much thought to the need to make a distinction to the client and/or attorney when those terms are co-mingled. This stems mainly from the mindset that it is often challenging enough to get clients to understand the need for a financial expert in the first place, and tend to want to avoid muddying the waters on an issue that appears to be benign at the onset.

Based on the direction that academia is heading, whereby curriculum are being re-defined to incorporate fraud and forensic accounting concepts with the already established audit and accounting based course offerings⁶, it ap-

pears that it is time for our profession to start sorting out the components of this terminology goulash. Well, at the very least, it is time for us to embrace the need to re-educate ourselves and the public on the nuances between fraud, forensic accounting, and financial forensics – and why they matter.

Fraud Defined

Fraud – generally defined as intentional deception resulting in injury to another⁷. Fraud usually consists of a misrepresentation, concealment, nondisclosure of a material fact, or at least misleading conduct, devices, or contrivance. Courts

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have a tendency to refrain from defining fraud in order to avoid being too narrow or too broad, thereby negatively affecting cases that may subsequently arise.

There are at least two specific and generally accepted distinctions that fall under the fraud umbrella:

- **Fraud in fact** – (also termed actual or positive fraud) that is a concealment or false representation by means of a statement or conduct that causes injury to another.
- **Legal fraud** (also termed constructive fraud) – that is unintentional deception which causes injury to another.

There are numerous nuances to the definitions available for fraud that include descriptor words such as misrepresentation, recklessly, with intent, unconscionable dealing, actionable deceit, conspiracy to defraud, unconscionable use of power, and unconscionable bargain, as well as labeled frauds: constructive fraud, extrinsic fraud, intrinsic fraud, fraud in the inducement, fraudulent conveyance⁸.

The takeaway: the term fraud by itself is ubiquitous, and occupies shifting ground. It is a chameleon term best used with a modifier. The financial expert engaged in a litigation matter will most typically be dealing with fraud in fact⁹ as the claim in the case, and will not render an opinion regarding intent. In this instance, however, the financial expert could give an opinion regarding whether or not the actions of the defendant meet the definition of appropriation¹⁰, for example, in addition to quantifying the amount appropriated.

Forensic Accounting/ Accountants Defined

Both in academia and in practice, “forensic accounting” is widely discussed, but a clear definition has yet to be formulated. Although it seems that forensic accounting has a long been a part of our country’s history (think: Al Capone’s 1931 indictment for income

tax evasion), the term was first coined by Maurice E. Pelaoubet in 1946, whereby he stated that, “during the war both the public accountant and industrial accountant have been engaged in the practice of forensic accounting.”¹¹

In 2006, Gordon Brown, Chancellor of the Exchequer¹², stated the following: “What the use of finger prints was to the 19th century and DNA analysis was to the 20th, *forensic accounting* will be to the 21st century.”

Unfortunately, neither Pelaoubet nor Brown took the time to define forensic accounting. Much like the term Fraud, there is no unified definition of *Forensic Accounting*. As such, we start with the basics of the terms used.

Forensic science (often shortened to forensics) is the application of a broad spectrum of sciences to answer questions of interest to a legal system. Black’s Law Dictionary defines Forensic as “used in or suitable to courts of law.”

In my quest to find a unified definition of forensic accounting, I came across the following entries:

Forensic accounting is defined in a 2007 textbook as “the action of identifying, recording, settling, extracting, sorting, reporting, and verifying past financial data or other accounting activities for settling current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes.”¹³ [*“Past financial data” should be used “for projecting future financial data” only in cases where it is expected that the past will repeat itself. Ed.*]

Forensic accounting services are defined by the AICPA as the application of accounting principles, theories, and discipline to facts or hypotheses at issues in a legal dispute and encompass every branch of accounting knowledge.

Forensic accounting is defined in a journal as being “focused upon **the identification, interpretation, and communication of the evidence of economic transactions and reporting events**. The ultimate goal of a forensic accountant is to communicate an analysis of this evidence, structured

within some legal framework, so that it is understood and accepted as fact with “scientific certainty;” that is, to present “a legally accurate accounting.”¹⁴

I next delved into the term *forensic accountant* in order to gain further insight into the definition of forensic accounting. The theory here is that the description of what a forensic accountant does would help identify what forensic accounting is.

As described in an article on forensic accounting: “*Forensic accountants* look behind the deals and handshakes and probe beyond the numbers to uncover the reality of financial situations.”¹⁵

As described in a textbook, “A forensic accountant may take on fraud auditing engagements and may be a fraud auditor, but he or she will also use other **accounting, consulting, and legal skills in broader engagements**. In addition to accounting skills, he or she will need a **working knowledge of the legal system and excellent communication skills** to carry out expert testimony in the courtroom and to aid in other litigation support engagements”¹⁶.

As described on a practitioner’s website, “Accountants look at the numbers. Forensic accountants look behind the numbers® ... Our team of certified **forensic accountants...** will not only find financial discrepancies—they’ll find out who, what, where, why, when and how—all during the course of our forensic accounting financial investigation. More importantly, we’ll help you put together and implement systems and controls to prevent internal or external fraud from happening again.”¹⁷ (*It is interesting to note in this last reference the blending of forensic accounting and fraud deterrence.*)

As described by a forensic certification organization, “*Forensic accountants* are professionals who use a unique blend of education and experience to apply accounting, auditing, and investigative skills to uncover truth, form legal opinions, and assist in investigations.”¹⁸ [*While the above is a quote, it is the opinion of the Editor and Board that the goal of the Forensic Accountant*

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is to uncover facts and report the results of their procedures. We are of the opinion that it is the job of the fact finder to determine the "truth" of a matter and the job of counsel to form and argue "legal" opinions. Ed.]

The descriptions of forensic accounting listed above vary from applying accounting principles, to analyzing evidence and forming legal opinions. The commonalities held amongst the definitions include using Generally Acceptable Accounting Principles as a framework for analyzing financial information and applying it in the legal system of criminal and tort law. As a practitioner I do not believe we can reach legal opinions; that power is held exclusively by the triers of fact, but a forensic accountant can assert whether an action meets certain legal definitions such as misappropriation.

Based on the above, a singular and succinct definition of Forensic Accounting could be: **the application of GAAP for legal purposes and/or to answer questions of interest regarding GAAP to the government or courts of law.**

Financial Forensics Defined

Financial Forensics was a bit more of a challenge to find definitions than for fraud, forensic accounting and forensic accountants. This lack of data indicates to me that its use, and those who jump on the Financial Forensics bandwagon, are standing at the very precipitous vantage point as to morphing their talents to the needs of the public, rather than repeating what has been done for decades regarding financial consulting.

A Google search for "Financial Forensics" turned up 2.11 million hits. Further refined, 1.6 million of those hits were considered 'reviews' and approximately 33,500 hits were in 'threads'. The only other filter is videos, which was approximately 500 hits. There were no determinable definitions for "Financial Forensics" that I could find. There were, however several articles and blogs dating from mid 2008 forward using "Financial Forensics" in their titles – yet none defining the terminology in their content.

At the top of the list on Google for "Financial Forensics" were two practitioner websites. The first one, interestingly enough, does not define financial forensics at all. The term on the website is accompanied by a regis-

tered trademark symbol, and is used as their business name.

The only item I could glean from the site is a description of expert witness services regarding "...developing and delivering damages calculations as required by statute and/or court cases. Our approach pivots upon delivery to the trier(s) of fact and is tailored to the available data and documents using technical methods such as "full and false inclusion", "attribute testing", "ratio extrapolation" and related methods necessary in forensic accounting matters."¹⁹

The next two hits were for organizations that designate experts using the terms "Financial" and "Forensic(s)" in the name of the credential, the CFFA and the CFF.

"The Certified Forensic Financial Analyst (CFFA) credential is offered through the Financial Forensics Institute. It is designed to provide assurance... that the designee possesses a level of experience and knowledge deemed acceptable by the Association to provide competent and professional financial forensic support services. Applicants can train in one of five areas of specialty, any of which lead to earning one's CFFA credential. Those areas are:

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¹ <http://www.merriam-webster.com/dictionary/goulash> Main Entry goulash. Function: noun. Etymology: Hungarian guly's, short for guly-sh's, literally, herdsman's meat. Date: 1866. 1: a stew made with meat (as beef), assorted vegetables, and paprika. 2: a round in bridge played with hands produced by a redistribution of previously dealt cards. 3: a mixture of heterogeneous elements: jumble. Cite dated 07/29/2009.

² Universities are preparing for the U.S. transition to IFRS: 80% of accounting programs surveyed indicated that they offer courses in IFRS material; 15% plan to add IFRS to the curriculum by fall 2009. <http://www.journalofaccountancy.com/Web/20091963.htm> cite dated 07/29/2009.

³ Ibid.

⁴ <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/chapter1.pdf> cite dated 07/26/2009.

⁵ Swartz, Watkins, Power Failure: The Inside Story of the Collapse of Enron. Chicago: Doubleday, 2003, Appendix D.

⁶ For an in-depth analysis of the current debates in the academic world regarding this issue, see Smith, Crumbley. "How Divergent are Pedagogical Views Toward the Fraud/Forensic Accounting Curriculum?" Global Perspectives on Accounting Education; Volume 6 (2009). pages 1-24.

⁷ There are over eighteen definitions for fraud and types of fraud in Black's Law Dictionary.

⁸ A complete discussion of these nuances is outside the scope of this article.

⁹ The terminology used in the complaint will vary by region locality court

¹⁰ The exercise of control or taking possession of another's property.

¹¹ Maurice E. Peloubet, "Forensic Accounting: Its Place in Today's Economy," Journal of Accountancy 81 (6) (June 1946), pp. 458-462.

¹² Chancellor of the Exchequer is the title held by the British Cabinet minister who is responsible for all economic and financial matters. Gordon Brown is now the Prime Minister of the United Kingdom. Brown became Prime Minister in June 2007, after the resignation of Tony Blair.

¹³ Crumbley, Heitger, Smith. Forensic and Investigative Accounting. Chicago: CCH, 2007.

¹⁴ As defined by the Journal of Forensic Accounting.

¹⁵ D.W. Squires, "Problems Solved with Forensic Accounting: A Legal Perspective," Journal of Forensic Accounting. Vol. IV (2003), p.131.

¹⁶ Crumbley, Heitger, Smith. Forensic and Investigative Accounting. Chicago: CCH, 2007.

¹⁷ http://www.investigation.com/forensic_accounting.htm cite dated 07/27/2009.

¹⁸ http://www.acfei.com/forensic_certifications/crfa/ cite dated 7/30/2009.

¹⁹ http://xr440.sterling.net/~admin59/index.php?option=com_content&task=view&id=1&Itemid=1 cite dated 07/30/2009.

²⁰ http://www.nacva.com/certifications/c_cffa.asp cite dated 07/29/2009.

²¹ <http://fvs.aicpa.org/Memberships/Overview+of+Certified+in+Financial+Forensics+Credential.htm> cite dated 07/26/2009.

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Financial Litigation; Forensic Accounting; Business Fraud–Deterrence, Detection and Investigation; Business and Intellectual Property Damages; and Matrimonial Litigation Support.”²⁰

“The Certified in Financial Forensics (CFF), combines specialized forensic accounting expertise with the core knowledge and skills that make CPAs among the most trusted business advisers. The CFF... skills... apply in a variety of service areas, including: bankruptcy and insolvency; computer forensics; economic damages; family law; fraud prevention, detection and deterrence; financial statement misrepresentation; and valuations.”²¹

The commonalities held amongst the financial forensics definitions include the analysis of financial information and applying it in the legal system of criminal and or tort law.

Given the above, I believe a reasonable definition of Financial Foren-

sics could be: the identification, interpretation, and communication of the evidence of economic transactions for use by the legal system.

Conclusion

Financial Forensics is a much broader definition encompassing significantly more areas of consulting by the financial expert than Forensic Accounting. The difference between Forensic Accounting and Financial Forensics should be whether or not the analysis includes the application of Generally Accepted Accounting Principles. If you represent you are a Forensic Accountant, make sure you have a clear definition of the area of GAAP you are being asked to analyze, and the ultimate services provided.

Fraud and Financial Forensic engagements would typically involve either tracing financial data for detection of misappropriation (fraud) or calculating damages based on the claim in the case (financial forensics). By definition, neither of these types of engagements would require adherence to, or the analysis of, GAAP related concepts.

The definitions that I propose herein are based on the literal definition of the components of each term, and are a first stab at a final definition. Each word has meaning, and I think thus far have not been specifically defined in these combinations because the meanings are presumed to be self-evident. I think it is time that we, as a profession, define or delineate the nuances between them.

Ms. Masten is the managing Director of Masten Valuation in Denver, Colorado. She focuses her professional time on litigation, goodwill impairment testing, business valuation, and consulting services as they apply to both private and public companies. Ms. Masten earned a Master of Science in Accounting degree from Texas Tech University, is a member of the national instructor team for NACVA, and is currently fulfilling a three year elected term on NACVA's Executive Advisory Board. Masten can be reached at lari@mastenvaluation.com or (303) 331-4430

MURPHY'S LAW

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case back to the district court. Accordingly, a few years had passed between the time the expert report was prepared and the trial began.

The plaintiff's counsel was an experienced litigator, with over 100 jury trials. However, the Supreme Court had not yet ruled that Daubert challenges should be applied beyond scientific expert testimony. The trial judge decided to apply the Daubert rules to a damage analysis “in an exercise of caution”. The plaintiff's attorney and I had no prior experience with Daubert challenges, and we were in uncharted territory.

Bad Timing

My son was born the night before the hearing, and I was in the hospital until 2:00 a.m. the morning of the hearing. Counsel had no warning of a Daubert hearing. He asked me to be

present to listen to some of the trial testimony, even though I was not expected to be called as an expert for at least a week. I had not done any work on the file between the issuance of my report and the morning of the hearing. I was up late and had only a few hours of sleep when I entered the courtroom at 9:30 a.m. Counsel informed me that the Judge had a few questions for me, and a hearing would commence at 9:45 a.m. I had 15 minutes to review my report.

Case Outcome

Opposing counsel started slowly, but the Judge quickly took control to find answers to his questions. He asked about my background, education, experience, use of industry publications, use of a learned treatise and other issues related to damages methodology. At times I felt he was being tough, and I almost offered an explanation of the prior night's activities to explain my sleep deprivation, but decided against doing so. His last

question was “Do you remember the name of the Federal Judge in the other trial in which you testified?” I did, and he flashed a great smile, proclaiming “We love it when you remember our names!” I sensed a real change in momentum. The hearing was soon over, the trial continued in front of the jury, and later that day the Judge's clerk issued the Judge's opinion. The Judge had no difficulty concluding that I was qualified, and allowed my testimony. The jury returned a verdict in favor of the plaintiff and awarded him in excess of \$1,000,000.

Lesson Learned #1 – Remember the Name of Judges

The reason the Judge wanted the name of the other Judge was so that he could include my prior testimony in Federal Court in his opinion. He has since passed away, but the memory of his wide smile is etched into my mind.

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