

Forensic Accounting – Fraud, Non-Compliance and Disputes

“An auditor is like a watchdog. But a forensic accountant is like a bloodhound”.

Forensic accounting, simply put, is the detailed analysis and reconstruction, if necessary, of accounting and other business records in relation to matters that may ultimately be adjudicated by a civil or criminal court of law, a regulatory body or other forum. It is generally performed because of concerns about the integrity of – accounting records and financial information, actions by personnel or other organizations, or business transactions and operations. The detailed analysis, when synthesized with third party data and documents, interview evidence and an understanding of business processes and transactions, results in a deeper factual understanding of the what, who, when, how and why of the situation. Whether in a civil, criminal, regulatory or investigative situation, the forensic examination and insights can be the basis for determining how to proceed.

Forensic accounting is not comparable to auditing a company’s financial statements or specific transactions. We look at much more than just numbers. Developing and executing the analysis needed to understand and clarify a complex business issue requires a forensic accountant’s “investigative mentality”, looking not only for what is there but also what isn’t that should be. FirstRule Financial goes beyond what happened – probing to determine whether it was intentional, how was it possible, who was aware and who benefited. In short, we use document and transaction analysis, synthesized with other evidence, to bring clarity to complex financial issues.

Some of the most significant value that comes from our forensic approach is in the process issues we have identified. In many cases, because of our detailed examination of the processes we have identified controls not working as believed, process and control design deficiencies, and process inefficiencies. With an understanding of risks and processes, we have brought ideas and solutions to our clients resulting in significant cost savings going forward.

Examples of some of our cases follow.

Our Experience

Procurement Fraud

A multi-national retailer was concerned that a supplier may have been overcharging. FirstRule Financial was immediately retained to perform a forensic examination of the purchasing from all suppliers encompassing the processes, purchases, returns, accounting and financial impact. Our analysis found tens of millions in fraudulent billings which, in conjunction with other evidence, led to criminal charges against a vendor and an internal employee who had collaborated to keep the fraudulent invoices from being uncovered. We provided testimony and our analysis was used in court to show patterns of conduct and to quantify the fraud at \$41 million. The vendor was convicted, the employee pled guilty, and the company recovered many millions. We also identified other process issues and provided input into strategies and processes to reduce risk and control costs. In addition to recoveries, the company realized even more significant cost savings from process changes.

CEO Expense Reports and Perks

The Audit Committee of a public company which operated a national chain of over 100 restaurants was notified by its external auditor of concerns about the CEO's expenses. FirstRule Financial was retained to perform a forensic examination of his expense reports and other perks he received over a four-year period. Our analysis identified hundreds of thousands of dollars in unsubstantiated, duplicate and personal expenses claimed, as well as unauthorized compensation. The CEO left the company.

National Restaurant Chain Examination of Financial Statements and Operations

The same national chain under a new CEO and CFO requested FirstRule Financial to examine certain unusual journal entries. Our initial examination indicated a potential integrity issue with management and possible collusion with a vendor. We were requested to expand our examination into a full forensic examination of the company's accounting, financial reporting and operations for the prior four years. Our examination uncovered significant irregularities involving vendors, management activities, and numerous areas of accounting irregularities. We assisted the company in the restatement of the financial statements and also in the subsequent SEC examination. The company turned our report over to law enforcement leading to criminal charges and guilty pleas by the CEO, CFO and CIO.

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International Procurement Integrity

FirstRule Financial was retained by a multi-national corporation to perform a forensic examination of its procurement process related to specific manufactured to order products imported from Asia that were found to be of sub-standard quality. The company wanted to understand how the process breakdown occurred, the extent of involvement and/or knowledge of its own personnel, whether there were issues that could affect the integrity of its overall procurement processes, and what other financial or accounting issues were involved. We identified significant factual findings as well as numerous process and control deficiencies, and provided input into future risk mitigation strategies and processes.

Wage and Hour Class Action

Employees of a major US retailer brought a wage-and-hour class action lawsuit in the State of Minnesota. We were asked to analyze, on behalf of the plaintiffs, the extent of missed breaks and time spent working “off the clock” (OTC). To perform this comprehensive analysis, we obtained all point-of-sale (POS) data for a period of 6 years (hundreds of millions of records) and combined this with the applicable timecard data to determine if an OTC instance occurred for personnel who worked on a cash register. We also used computerized data from computer-based-learning (CBL) exercises with the timecard data to determine if CBL’s were conducted OTC. Using data from the POS, timecard, CBL, PeopleSoft human resource system and payroll adjustments, we were able to quantify the actual number of OTC instances and time as well as missed break occurrences. This information helped achieve a \$54 million dollar settlement on behalf of the employees.

T&E Anomalies

A major US corporation, with tens of thousands of sales personnel, wished to conduct analysis of submitted and approved Travel and Entertainment (T&E) transactions for potential fraud or non-compliance with Corporate T&E guidelines. Utilizing transactional data from both the Concur™ T&E system and Oracle Human Resources system, we wrote routines that were utilized to identify statistical “outliers” (large \$ amounts) within the categories for meals, air travel, rental car, hotel and miscellaneous transactions; abuse of expenses not requiring payment support/receipts; duplicate claims over multiple periods; and transactions occurring before a sales person’s hire date or after their termination date; to name just a few. Within the first year of operation, the T&E exception reports resulted in more than 200

investigations of sales personnel where fraud and non-compliance was noted.

Professional Conservatorship Examination

A county probate court retained FirstRule Financial to perform a financial examination of a professional conservatorship organization. We identified certain financial issues resulting in recoveries but more importantly we identified an opportunity to significantly improve the regulation of conservators. We suggested that the paper based annual reports be submitted on a web based system. At the Court's request, FirstRule Financial developed a white paper with a design for the web based reporting system that has been implemented. This reduced the workload for Court staff and made monitoring compliance more efficient. This has attracted national attention from other states.

Investment Litigation

A not-for-profit organization invested in a venture that was to build a cattle slaughter, processing and distribution operation. Ultimately, the plant that was to have been built was not, and the operation failed. We were asked to examine the use of the invested funds, cash flows and the results of operations as compared to representations. Using the findings from our examination, a lawsuit was initiated which was settled with significant recoveries by the not-for-profit.

Financial Institution Loan Examination

A credit union noticed irregular behavior by one of its loan managers. We performed a forensic examination of the loan portfolio. Several fraudulent loans were identified but because of the timeliness of actions taken to address the loans, no losses were suffered.

Criminal Defense

An attorney defending a director of a corporation charged with criminal fraud requested FirstRule Financial to provide forensic analyses to help him understand the financial realities of the situation. This involved analyzing entries through the general ledger, loan transactions and returns on investments.

Branch Propriety Examination

A national retailer operated a subsidiary company in a southern state to perform repairs on its stores around the country. The subsidiary did its job well but when a question arose about certain labor costs, we were asked to perform an onsite examination, to look under the covers. Our examination of the operations and accounting determined that all costs

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incurred during the year were allocated to the stores. Accordingly, the sub showed no income or loss and drew no attention. The stores had no idea what the cost allocated to them should have been and so were not a control over the expenses. We found that, without any effective control, the manager of the repair operation had been manipulating the budget to provide significant excess funds that were used to pay personal expenses. These had been passed on to stores for years without any question.

Inventory Loss

A multi-national corporation's internal auditors had identified an apparent inventory loss at a third party warehouse on the east coast. However, after much digging and analysis, it still wasn't known if the loss was a real loss or if the inventory records were overstated. When we were called in, our first step was to understand the production operations associated with the inventory and the workings of the inventory accounting system. We next attended at the warehouse site to interview management and staff and review the accounting entries originating at the warehouse. It became apparent that we weren't being told everything by the warehouse owners. Our reconstruction and analysis of the incoming and outgoing shipments against the entries to the accounting system made at the warehouse showed that the problem was definitely at the warehouse, where major, regular shrinkage was occurring. Through discrete questioning of warehouse floor staff, we found two sets of production records. The accurate records showed that part of the inventory received was being processed as the warehouse owner's personal brand, but not recorded as such. With this knowledge and documentation, our client was able to restructure its operation and take appropriate action against the parties involved.

Ponzi Scheme

An apparent successful property developer/businessman convinced members of the community that they too could be the success he was if they invested in his companies. In typical fashion, he provided cash returns initially to show he was legitimate but then suggested investors leave their profits with him to reinvest. This went on for four years before serious concerns arose. We were hired by the prosecutors to work with law enforcement to analyze and document the true nature of his operations. With a few hundred investors and approximately 10 companies, 20 bank accounts and several bank lines of credit, the reconstruction of the investments, cash flows and actual business operations was a major undertaking. Significant to our analysis was that the businesses he set up didn't have legitimate operations as demonstrated by cash flows, and investors' funds were used to pay for his luxurious lifestyle and to pay prior investors who threatened legal action. We presented this evidence in a criminal trial that ended with his conviction.

Bad Credit

An Asian based computer chip manufacturer sold product to numerous European companies through its sales office in London. When the European operation suffered significant credit losses, we were asked to perform an examination of the operation and causes for the losses. Our examination ultimately determined that the European manager had not followed appropriate diligence on customers before accepting their orders on credit. The defaulting accounts were related and were part of a criminal operation.

Post Acquisition Dispute

A large national company had acquired a mail order business, which was seen to be the way of the future in the industry. It was expected to have significant free cash flow and dramatically add to the bottom line. After three months of post acquisition operation, the new company was found to be losing millions of dollars per month. Management called in forensic accountants to examine the operations and accounting of the acquired company, find the reasons for the cash requirements and whether our client had been misled in the acquisition process.

It became apparent that the acquired company's actual pre-acquisition performance and results were much different than had been represented to our client. The acquired company had seen its actual bottom line deteriorating over the prior two years but had been able to use purchase reserves, and other accounting entries, to portray revenue and bottom line growth, earning a high multiple on its sale. As a result of the findings, the company took corrective action to stem the operating losses as well as take legal action against the vendor principals.

Rightful Dismissal

An independent financial institution hired a new manager from a competitor. When the next review was performed by the regulator, certain inconsistencies were noted in the approval process of credit facilities provided to the manager. We were requested to analyze the manager's transactions through credit facilities and deposit accounts. The analysis of the use of funds from his loan accounts led back to other credit facilities at his prior employer which, it was determined, had not been properly approved. Using the facts from our analysis, the manager was interviewed and subsequently terminated.

Insurance Regulatory Compliance

An insurance brokerage branch was making inordinately high profits for the volume of business it placed. Management was pleased, but employee turnover was very high. When a client reported it had inappropriately been charged both fees and commissions, the regulator required a review of billing practices. We were retained to analyze the

profitability of the branch office and, in particular, its revenues and billing practices. It was determined that there was a systematic pattern of overcharging clients that was orchestrated by the branch manager. An examination of approximately 18,000 files ensued which enabled the company to repay its customers and settle regulatory actions. The manager was dismissed.

Royalty Dispute

An author of several statistical treatises had licensed her work to a global publisher of technical text books. Although she was receiving regular royalty payments she noticed inconsistencies in the accompanying royalty reports. When the matter was taken to court, the court ordered the company on two occasions to produce a comprehensive report; and on two occasions they complied but the reported sales numbers changed and neither agreed with the original data. The court then ordered a third party be brought in to prepare an accurate royalty report.

The task was very complex. The publisher operated five different sales systems in different countries. It published texts in multiple languages. Each text had a parts list for each edition and language. Contract terms differed for different part numbers and over time. Finally, manufacturing overruns, promotional issues and returns had to be factored in.

Our examination identified the necessary data from each system and the key fields that would allow us to join and analyze the data. Using current and historic data, we ensured completeness of part numbers and traced them to texts and to sales of those texts; ensuring the sales data used tied back to audited financial statements. We applied contractual royalty rates to sales data for the relevant time periods and examined printing invoices, shipping records and inventory reports to substantiate the reasonableness of the sales figures compared to the numbers of recorded sales. We also obtained data on promotions and returns and ensured that they were properly handled. Throughout the process we communicated with both sides to the dispute to verify our process and address any issues they had with our methodology.

This examination resulted in a report that was accepted by the court and both parties to the dispute. Process issues identified during the course of the examination were useful to the publisher in identifying corrective actions.

Royalty Dispute

A company developed a design for a new compact heater, but did not have the manufacturing capability to produce them in economic quantities. The company entered into a licensing agreement whereby the product would be produced offshore, imported and distributed. Royalties would be paid under the licensing agreement. The company

believed the royalties were being under-reported. We were retained to examine the royalty reporting. The royalty reports were compared to the distribution records, orders, manufacturing and customs records. The reconstruction showed royalties were under reported. Not only were all sales not reflected on the royalty reports, the comparison of manufactured units compared to customers documents showed manufactured units were being diverted and sold in other markets. A settlement was reached using our analysis.

Shareholder Dispute

A real estate management company was about to be acquired and a substantial profit realized. The minority shareholder, who had been the operating partner, sued the majority partner claiming he had been promised an additional 5% interest. The majority owner disputed the claim. We were retained by their counsel to examine the business records. The claim stated that the minority shareholder had been promised the additional 5% because of superior performance. An unsigned agreement supported this. However, the majority owner claimed that this did not occur because the minority shareholder had requested and been given a bonus and increased compensation instead. Our analysis showed that a bonus had been paid and his compensation was increased. But there was no conclusive evidence to show this was to replace the share agreement. During our examination of the operations, however, we discovered that the minority shareholder had systematically been defrauding the company of substantial funds through false personal and operating expenses. With this additional factual evidence, the case was quickly resolved.

False Credit

A multi-branch bank had loaned significant amounts to a construction company. It monitored the account regularly and believed it was well secured. When the monthly financial reporting was not received, the bank attempted to contact the company without success. Two weeks later, the company ceased operations. The bank found that there were virtually no assets to secure its position.

We were retained to examine the circumstances which led to this situation. Our analysis of the reporting to the bank showed that the security reporting did not reflect the operations or actual changing financial position of the company. Further undisclosed liabilities to related parties had been paid off through conversion of the bank's security. Using our analysis, the attorneys for the bank were able to make a significant recovery.

Breach of Trust

A prominent lawyer, acting on behalf of his land developer client, accepted funds under trust conditions from numerous investors. When the developer declared bankruptcy, investors were informed that there were no funds to repay them. We were retained to examine the use of funds entrusted to the lawyer. Our reconstruction of the transactions through over 100 trust accounts showed a pattern of transfer of trust funds to unrelated accounts. The analysis showed that the funds were ultimately used for purposes unconnected to the original investments. Our report was used in civil and criminal actions. A settlement was reached with investors recovering significant amounts. The lawyer was convicted of multiple charges of fraud.

Gift Card Fraud

A company in the hospitality industry was contacted by customers who had purchased gift cards only to find when they presented them for payment that the cards value had already been used. The company had discovered that those cards had been used by the same person but requested our assistance to help them investigate the scope of the thefts and how they could best mitigate the risk of continuing losses. We were able to identify the scope of the first identified issue and uncover other scams by examining data from several systems using analytic software from Arbutus Software. The analysis also identified weaknesses in processes and controls which we used to define ways to mitigate losses going forward.

Foreign Corrupt Practices Act (“FCPA”)

A law firm representing a major construction firm required forensic accounting expertise to investigate and respond to charges under the FCPA. Through analysis of the accounting records we identified disbursements to 3rd parties of interest and assisted the law firm to investigate the payments, including how they were initiated, who had participated, who had knowledge, and how they were accounted for and reported.

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The preceding case examples illustrate some of the situations where our forensic accounting expertise was instrumental in bringing clarity to a complex financial issue contributing to its resolution. As a general rule, in any situation with concerns about fraud, regulatory or policy non-compliance, the propriety of financial information, or disputes with financial issues, forensic accounting can add significant clarity to the understanding and reporting of what actually occurred. We understand the evidence potentially available from the books and records of organizations and individuals, the type of analysis which will assist in addressing the issues of the case, and how to report it so that others will clearly understand the situation.

FirstRule Financial's experience in forensic accounting encompasses hundreds of cases nationally and internationally. Our experience can assist you by bringing clarity to complex financial issues.

If you would like to find out more about our forensic accounting capabilities, please contact Mike Mumford at 612-239-8014 or by email at mike.mumford@firstrulefinancial.com.