

1 **Accountant Liability for Undetected Fraud—Case Histories**

Representing Accounting Firms and Profesional Liability

Insurers

Admitted in Florida, Massachusetts and Vermont

© 2012 Gary H. Barnes, P.A. All Rights Reserved

2 **Financial Fraud**

- Definition. Deliberate and intentional misstatement of financial information, regardless of the manner of communicating the untrue information.

3 **Embezzlement Definitions**

- Formal Definition
- -Reality: Misclassification

4 **Ponzi Schemes**

- *A fraudulent investment plan in which the investments of later investors are used to pay earlier investors, giving the appearance that the investments of the initial participants dramatically increase in value in a short amount of time.*
- A Ponzi scheme is a type of investment fraud that promises investors exorbitant interest if they loan their money. As more investors participate, the money contributed by later investors is paid to the initial investors, purportedly as the promised interest on their loans. A Ponzi scheme works in its initial stages but inevitably collapses as more investors participate.

5 **On the Lookout For Financial Fraud**

Motivation

Loan covenant compliance (A/R kiting)

Buy Time For Internally financed operations

Buy Time to Earn Back Unexpected Losses

Retiring- Sale of Business- (A/P understatement)

Hide Cost overruns

6 **On the Lookout For Financial Fraud**

Opportunity to Discover

Loan covenant compliance (A/R kiting); repeated delays in getting excel spreadsheet for A/R not tied to general accounting system.

Buy Time For Internally financed operations. Tax return prep: substantial investment with no loan or other capital infusion.

Buy Time to Earn Back Unexpected Losses. (same case)

Retiring- Sale of Business- (A/P understatement)Advice , but not due diligence, at sale of business; advice to Buyers, buyer waste, weak buyer due diligence, strong P&S protections).

Hide Cost overruns. Misclassification to hide programming cost overrun.

7 **On the Lookout for Ponzi Schemes**

Common Elements:

- Unusually high rates of return
- Limited investment opportunity
- Hi-flying promoter

8 **Ponzi Schemes In Operation**

- the savvy commodities trader: the O'Connell Ponzi scheme
- Financing "secret" settlements: The Rothstein Ponzi scheme
- Investment opportunity done as a "favor" to the investor: the Wilkinson Ponzi scheme
- The Insurance Premium finance Ponzi Scheme
- The desperate principal: the Sardine Canyon Ponzi scheme

9 **How to Avoid Ponzi Schemes**

- Does the investment makes sense?
- Is the rate of return reasonable?
- Is the investment endorsed by a friend, family member, church member?

10 **How to Avoid Ponzi Schemes**

- Is there pressure to “get in early”?
- Does the investment involve a special loophole or tax avoidance scheme?
- Is there pressure to keep the investment “secret.”
- How new is the business? What is its track record in other locations?
- Have you done a background investigation on the principals? A criminal background check?

11 **How to Avoid Ponzi Schemes**

- Have you verified all of the sales presentation assertions?
- Does the deal require or involve kickbacks, complicated marketing schemes, or unwritten promises?
- Has the promoter provided audited financial reports, for several years. Has the promoter switched auditors? Is the audit firm real and substantial? Have you checked with the audit firm to see if any of the financial statements have been withdrawn? Have you checked with the state Society of CPAs, or with the PC AOB to determine if the accounting firm has been reprimanded or is in good standing?

12 **How to Avoid Ponzi Schemes**

- Does the investment return assume continued inflation or appreciation predicting attractive rates of interest?
- To achieve investment success is their reliance on someone's "unique expertise" or special skills?
- Is there some form of guarantee promised? Have you verified the guarantee? Is the guarantor viable? Have you checked the background of the guarantor?
- Is there liability exposure beyond the amount invested?
- Is the investment opportunity being promoted by a person who is living ostentatiously?

13 **How to Avoid Ponzi Schemes**

- can the investor and afford to lose the full amount of the investment?
- What portion of the investors portfolio does this and other high rate rate of return investments comprise?
- Can the investor keep his investment at a low level?
- Are the principals in desperate straits?

14 **Adventures in Embezzlement**

- the "lucky" CFO.
- The super-competent solo bookkeeper.
- The remote operation with a separate bank account
- The sexy bookkeeper with a large credit card bill
- The signature stamp that is kept "under lock and key"
- The CEO with large Travel and Entertainment expenses (herein the fox guarding the chicken coop)

15 **Adventures in Embezzlement**

- breakdowns in internal control discovered and utilized by the crooked bookkeeper.

16 **Common Characteristics of Embezzlement**

- The embezzler must have a means to get cash out of the business.

- The embezzler must be able to account for the embezzlement in the company's bookkeeping system.
- The embezzler must not live beyond his/her pre-embezzlement income

17 **Accountant Liability: Preventative measures**

- Preventing liability for financial fraud
- Preventing liability for embezzlement
- Preventing liability for Ponzi Schemes