

The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

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Fraud Prevention for Small Businesses—Including Our Own Firms

by Karen J. Kaseno, CPA

As forensic CPAs, we often assist with the investigation of a possible embezzlement or fraud, and help our clients repair the internal control deficiencies that allowed the fraud to take place.

Attorneys often request, and judges frequently appoint, a receiver to oversee a business in dispute after parties enter into litigation because the business lacks internal controls. The purpose of the receiver is to make sure that funds are being recorded properly and that the accounting or financial statements that are issued by the company are reliable.

Implementation of adequate internal controls in a small business is a necessity to safeguard assets and produce reliable financial statements.

On July 11, the Committee of Sponsoring Organizations of the Treadway Commission issued *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*. A copy can be ordered at www.coso.org. This publication offers good suggestions that most small businesses can use to strengthen their internal control systems and reduce the risk of fraud even if they are not a public company.

Among the suggestions are:

Establish an Atmosphere of Integrity and Ethics

Create a code of conduct that outlines

policies, including guidelines on billing, allowable levels of entertainment, limits on reimbursements, what is appropriate client contact, what constitutes a conflict of interest, and what level of gifts can be accepted.

Hire the Right Employees

The company should obtain background checks and consider obtaining a bond on all employees

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who handle company assets or are in possession of confidential client information. Hire competent employees who understand the importance of fraud prevention and accurate financial reporting.

Establish a Fraud Hotline

A fraud hotline is an inexpensive way to allow employees, and even vendors, to confidentially report possible problems or suspected fraud.

Assess Risks Inherent in the Financial Reporting Process

The company should have a good understanding of its risks and set objectives to manage those risks. They should review areas in which individuals could embezzle money or misstate financial statements.

Controlling incoming and outgoing cash is a concern in many small businesses. Frequently, the management of a business' bank account(s) is performed by only one person, with little or no oversight.

The bank statements for all of the bank accounts need to be sent to someone other than the person in charge of accounting. Start with the most important components of operations and implement controls in those areas.

Establish Procedures to Maintain a Current and Meaningful Accounting System

Procedures should be written with

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Section ACTION

Business Valuation by Cindy Craig, CPA

A recent article noted that one of Greenland's glaciers is racing down the mountains at twice the speed it moved in 1997. Sometimes it feels as if the valuation profession is moving faster these days, too.

Valuation practitioners need to be aware of changes made or anticipated—and what those changes mean in terms of how they practice and potential new valuation engagements.

The AICPA will again seek comments on the *Proposed Standards on Business Valuation* (Standards). At press time, the exposure draft was not available, but is expected to be out before the end of September. Visit <http://bvfls.aicpa.org/Resources/Business+Valuation> for updates.

The Appraisal Foundation and the International Valuation Standards Committee are trying to establish global standards by converging the Uniform Standards of Professional Appraisal Practice (USPAP) and International Valuation Standards.

The American Society of Appraisers (ASA) is seeking to revise its Business Valuation Standards to address intangible assets and intellectual property. More information can be found at www.bvappraisers.org.

USPAP 2006 is in effect and applies to all valuations prepared since July 1. For a summary of the changes in USPAP, go to www.appraisalfoundation.org, click on "Find Info On" or look for the July 2006 issue of *BV Update*.

Nonqualified deferred compensation plans have appeared as a potential new valuation opportunity, due to potential taxes that could be incurred under IRC Sec. 409A. Information can be found at www.irs.gov/irb/2005-2_IRB/ar13.html and "8 Things You Need to Know About Section 409A" in the June 8 issue of *Value Matters*, www.mercercapital.com.

The new IRS Appraiser Penalty Process, based on IRC Sec. 6701, includes a potential penalty of being disqualified to practice before the IRS. See the July/August 2005 issue of *Valuation Strategies* for an overview.

If you think something affects the work you do or could open the door to new valuation opportunities, pay attention to the approaching glaciers.

Cindy Craig, CPA, ABV is Business Valuation Section chair and the director of Business Valuation Services at Andersen & Company LLP in Santa Rosa.

Economic Damages by Colin A. Johns, CPA

Some believe the backdating of stock option grants by public companies is going to lead to the next big wave of litigation. What is this and does it present an opportunity for litigation practitioners?

Options are often granted to high-level executives of public companies as part of their compensation package and as an incentive to improve the company's performance. These options grant the recipient the right to purchase stock at a specified price—the exercise price—which is usually based on the stock price on the date of grant.

Among the issues being raised is whether those grant dates were selected retroactively (backdated) to take advantage of a low point in the stock price. However, the issue goes much deeper.

One starting point for a forensic investigation of such practices is to plot the daily closing prices of the stock over a period of time and analyze the data in terms of the timing of option grants.

A consistent pattern of granting options at or near the low point in the stock price may suggest further investigation. This is especially the case if the pattern illustrates a consistent decline in the stock price before the grant dates, perhaps in conjunction with negative press or other comments from the company, followed by a rise in the stock price after the grant dates that coincides with positive press or other comments from the company.

This "V" graph can draw scrutiny from the SEC and plaintiffs' counsel.

Since there may be other explanations for this pattern, other information should be examined, including the compensation committee's meeting minutes of when option grants were approved.

Many believe that the Sarbanes-Oxley Act requirement for quicker reporting of option grants eliminated the potential for backdating, but failures to timely report grants may also be indicators of possible backdating.

If backdating is identified, how the options were recorded by the company should also be analyzed to determine whether any difference between the fair value of the option and the exercise price was appropriately accounted for. In some cases, a restatement of a company's financial statements may be required.

Colin A. Johns, CPA, CFE, CA is Economics Damages Section chair and a director in the litigation and forensic consulting practice of Hemming Morse, Inc. in San Francisco.

Family Law by Tracy Farryl Katz, Esq., CPA

California Family Code Sec. 4058 defines "annual gross income" for each parent for purposes of computing child support as income from whatever source derived, except child support received and income from public assistance programs.

Code Sec. 4058(a)(1)–(3) provides examples of what gross income can include, but is not limited to, such as commissions, salaries, royalties, rents, dividends, interest, trust income, and business income net of required expenses for the operation of the business.

Despite the broad definition of income in Sec. 4058, two recent cases have determined that the accumulation of wealth from appreciating assets is not to be considered income available for support.

In *Henry v. Reissmueller* (2005, 126 Cal.App 4th 111), the trial court decided that the increase in the equity

of Respondent's residence could be considered income for purposes of computing child support. The Appellate Court overruled and stated that the statute uses the word "derived," which is indicative that the Legislature meant "money actually received, and not merely the appreciation in value of assets."

And earlier this year, the Appellate Court again interpreted the statutory definition of income for child support purposes in *In re Marriage of Pearlstein*. In *Pearlstein*, the trial court included, as part of Appellant's gross income for child support purposes, cash and the value of stock Appellant received for selling his business.

The court noted that "while the definition of income in Sec. 4058 is broad, it is not limitless, and generally, the types of income specified in the statute consist of money that the support obligor actually receives, and do not include unrealized increases in the value of assets." In quoting *Henry v. Reissmueller*, the court said, "if the Legislature had intended that the unrealized increase in the value of an asset should be considered income, it would have said so."

Family law practitioners should be aware of recent cases defining income for support purposes as they provide guidance for the accountant's calculations.

Tracy Farryl Katz, Esq., CPA is Family Law Section chair and a partner with Gursay Schneider & Co. LLP in Los Angeles.

Fraud

by B. Marie Ebersbacher, CPA

Fraud is everywhere, and rarely can a business avoid being confronted with fraud in some form. When a business or individual is faced with a financial crime, the first call is typically to their CPA. The advice they receive will shape the investigation.

There are several issues to consider at the start of any investigation. Does the client want restitution? Prosecution? Does the perpetrator have the ability to pay back the loss? Are there other entities, such as banks or other professionals, that may have contributed to the loss?

Message from the Chair

by Mark S. Luttrell, CPA

I am excited to begin my term as chair of the Litigation Sections. I am preceded by a long line of California CPAs who have made tremendous contributions to the profession in their role as chair of the Litigation Sections and its predecessor, the Litigation Services State Committee.

Outgoing chair Andy Mintzer led us through an unprecedented period of AICPA activity regarding litigation, valuation, and fraud. He helped position several Litigation Sections' members in prominent positions with the AICPA committees engaged in this activity and integrated our California leaders, who monitored, developed, and revised various publications and pronouncements that impact us.

I am eager to continue California's long history of leadership in these practice areas. With the rapidly changing landscape of corporate

governance, regulatory involvement, the evolution of standards, and practice affecting litigation consulting and expert witness work, we have a lot of work ahead of us.

I look forward to working with the talented group of CPAs comprising our Litigation Sections to address these unique challenges and provide our membership with the resources they need to excel in this practice area.

For CPAs who are not active members of the Litigation Sections, I encourage you to join and attend a meeting. I have been involved for 15 years and believe the experience gained and the friendships made are the most significant factors for my professional development in this practice area.

Mark S. Luttrell, CPA, ABV is the managing director of CBIZ & Mayer Hoffman McCann's Southern California offices.

One of the most important roles the CPA plays is explaining some of the grim realities of a fraud investigation. If the client is looking to prosecute, does the client understand the cost of an investigation? The sentencing guidelines with regard to loss in the client's jurisdiction also must be considered, but are often overlooked.

For example, someone may receive the same sentence for embezzling \$60,000 to \$500,000, so it may not make economic sense to quantify a loss of more than \$60,000, unless restitution is a genuine possibility. The true thresholds may be different from the statutory thresholds because of the budgetary constraints.

Defining the goals of the investigation is one of many decisions to be made.

Is the individual or company being defrauded obligated to inform investors or other entities of the loss? Is there a possibility of amending tax returns and preserving the statutes? Who must be informed if the company is a not-for-profit or a government agency, which may have a duty to investigate and quantify the loss regardless of the recovery potential.

Each decision must be made quickly with the correct information and protocol as to not jeopardize the investigation. Knowing these differences is often the distinction between traditional CPAs and forensic accountants.

B. Marie Ebersbacher, CPA is Fraud Section chair and a shareholder with CBIZ Mayer Hoffman McCann P.C. in Bakersfield.



What is Considered an Asset?

by Martin G. Laffer, CPA

SEC *v. Dennis Herula, et al.* (United States District Court for the District of Rhode Island, C.A. No. 02 154 ML) reminds us that the government's radar is always searching for fraudulent activity.

In September 2003, I received a call from an attorney with the Boston District SEC office advising me that the SEC had filed a motion with the U. S. District Court, District of Rhode Island, holding me, my firm and partner, and our clients' attorney and his firm and partner in civil contempt.

Simultaneously, the SEC faxed its claim alleging that we unlawfully accepted credit card payments for services rendered after the U.S. District Court issued an asset freeze order. The SEC also argued that we failed to petition the Court for payment of professional fees and should be held in contempt and return all fees.

The events surrounding the case made us wonder who decides what is considered an asset and whether credit card use is part of the definition of an asset.

Stage is Set

The case involves Dennis Herula, a registered investment advisor and stockbroker, and his wife, Mary Lee Capalbo Herula, an attorney licensed in Rhode Island, who were involved in various investment programs, along with other investors.

The Herulas retained our firm, along with legal counsel, in July 2002.

The SEC, concerned that the Herulas and others were improperly investing their clients' funds, petitioned the Court and was granted its request ordering a compilation of the Herulas' assets to determine if all invested funds transferred, paid, and invested were legitimate.

As part of the injunction, the Court permitted the Herulas to use funds unrelated to the fraud allegations to retain counsel and for other various expenses, subject to specified terms and conditions. The injunction was issued May 8, but the conditions that allowed fees to be petitioned were restricted from April 3–22, 2002.

Securing the Retainer

Our firm requested that the initial retainer be paid from funds excluded from the asset freeze, and not subject to forfeiture. Mr. Herula assured us that his friend and business associate, Claude Lefebvre, would advance the funds on behalf of the Herulas for their defense. The agreement was executed and we began work on the case.

A complicating matter was that Lefebvre was soon thereafter arrested. The government suspected that he and Mr. Herula provided an investment opportunity to a member of the Coors family, guaranteeing him a return of 75 percent per week on his investment of \$20 million. As a result, Herula was indicted for prime bank fraud, but was not arrested until June 2003. Both defendants were convicted after trial in Denver.

During the investigative work on the Herula case, our firm used the retainer fee and made requests for additional payments. The defendant's wife made the subsequent payments with credit card check advances. We were paid with credit card checks between July 2002 and January 2003, but then three additional credit card advance checks were returned for insufficient funds. As a result, we ceased all services.

Subpoenas are Issued

At that time, Mr. Herula requested that all documents be returned to his home in Rhode Island. Shortly there-

after, our firm, as well as the attorneys' firm, was subpoenaed, ordering a 30(b)(6) deposition and production of documents. This proceeding was pursuant to an order authorizing the SEC to conduct limited discovery in connection with contempt proceedings regarding Mrs. Herula. The requested documents included records of all payments, credit card receipts, and transfers of funds.

The records under subpoena were collected, reviewed with counsel and mailed in advance of the deposition to the SEC in Boston. I appeared July 8, 2003 at the Los Angeles SEC office for my deposition, which began with questions from the SEC pertaining to the asset freeze order.

I was asked to determine the time frame of when we had become aware of the order. The SEC also asked about authorizations from Lefebvre's bank account, and to confirm Mr. Herula's story concerning third-party commitments to pay the credit card charges and fund his defense.

I held that "my understanding was that no funds were being used that were frozen, and it was therefore unnecessary to petition the Court for funds to be released from the restricted accounts."

Payments a Violation?

The SEC's basis for its civil contempt motion was that the acceptance of credit card payments was a violation of the original asset freeze order against Mr. Herula. The SEC also alleged that our acceptance of payment via these credit card checks was an overt effort to override the court's order to abide by proper protocol in application for fees.

The SEC News Digest, under the headline "SEC files civil contempt charges against law firm and accounting firm for violation of freeze order," stated: "The Commission announced that it filed civil contempt charges on September 11, 2003 against the Los Angeles, California-based law firm of Geragos & Geragos and two of its attorneys (Mark Geragos and George Buehler) and the Los

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AICPA Alert

by Jeffrey H. Kinrich, CPA

The AICPA Forensic and Litigation Services (FLS) Committee met in early June, its final meeting before the AICPA's move to North Carolina. The move is phased over many months, with the departments relevant to FLS moving in mid-August.

Unfortunately, none of the talented and long-serving staff members who have supported the committee over the past several years will be making the move to North Carolina. The AICPA is actively hiring replacements, but there will be a transition period and loss of institutional memory.

Nonetheless, the committee and its volunteer members remain active and optimistic that the work of the committee will continue unabated. There will be between four and seven practice aids released this year, which will set a record for the FLS practice.

The *Intellectual Property* practice aid was released several months ago. The next FLS practice aid, *Lost Profits*, is due to be published in

September. Three firms, including California's Hemming Morse, Inc. and Ueltzen & Company LLP were instrumental in producing the practice aid in record time.

Two additional practice aids, *Financial Modeling* and *Analyzing Financial Ratios*, each an update of a previously issued practice aid, have been edited and are due to be released soon.

There also are two bankruptcy practice aids and a practice aid on how to deal with fraud discovered during an audit in the works, which may be released before the end of the year. Finally, based on a member survey, the committee has selected *Discount Rates in Litigation* as the next practice aid to be developed.

The FLS Committee accomplishes much of its work through task forces, including Fraud, Family Law, Economic Damages, Website Content, Editorial Advisory Board, and Litigation Process. The task forces are always looking for active volunteers, so let me or the AICPA FLS Committee know if you are interested in participating.

The Business Valuation Standards process continues. Last year's public exposure of the draft standards elicited much commentary, especially from the tax community. After reviewing the comments and having discussions

with interested parties, the developers have modified the standards to address many of the concerns.

The primary change will be to allow oral reports whenever deemed appropriate by the practitioner. The revised standards are expected to be re-exposed for a brief comment period shortly.

The standard is expected to be released later in the year with an effective date of Jan. 1, 2007.

The AICPA continues to promote and build the ABV credential and membership in the FLS Section. The number of ABVs continues to grow, reaching 2,000 in July. Continued growth is needed to achieve the AICPA's goals by 2008.

If you are interested in business valuation, consider obtaining your ABV credential.

This is my last *AICPA Alert* contribution as my three-year term on the FLS Committee expires in September. I have enjoyed my tenure and have gained tremendously from my time working for our profession.

I encourage each of you to get involved in some form with your practice area and your peers. The rewards are intangible, but very real.

Jeffrey H. Kinrich, CPA, ABV is a managing principal of Analysis Group in Los Angeles.

Fraud Prevention

Continued from Page 1

segregation of duties among employees, if possible. Have reports printed monthly and provided to the owners or an outside CPA for oversight.

Too many times we see accounting systems implemented with no one monitoring the system, the reports, or the output. The financial reporting system should be monitored so that meaningful financial statements are prepared and disseminated to the proper parties within a reasonable timeframe.

Many simple frauds would be detected simply through monthly analysis of bank statements and cancelled checks.

Clear Communication

The company's policies of integrity and ethics, and the rules as outlined in the code of conduct discussed above, need to be communicated to employees completely and frequently. Employees should sign a document acknowledging that they have received, read, and agreed to the rules.

Include adherence to these policies as part of the employee review process. Write memos or periodically

hold training sessions to remind employees of their individual responsibility to follow internal controls and to adhere to the code of conduct and antifraud policies.

These simple suggestions can help deter fraud in your company and can be suggestions for your small-business clients.

Some judges have found that implementation of strong internal controls and detailed reporting can save a small business from being ordered under the control of a receiver.

Karen Kaseno, CPA, CVA, CFE, CFFA is a former chair of the Fraud Section and her practice is based in San Diego.



H A P P E N I N G S

Litigation Sections Meetings

| | |
|--------------------|-------------------------|
| Business Valuation | Thursday, Sept. 28, OAK |
| Economic Damages | Wednesday, Oct. 25, SFO |
| Family Law | Friday, Sept. 29, OAK |
| Fraud | Tuesday, Oct. 24, SFO |

Each section will send individual meeting notices.
Download a copy at www.calcpa.org/LIT
or contact Bobbie Nochenson at (818) 546-3502

Education Foundation Course Offerings—(800) 922-5272 or www.educationfoundation.org

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|--|---|
| Business Valuation Fundamentals Part 2 | Monday-Wednesday Aug. 28–30, SF |
| Business Valuation: A Review of the Essentials | Wednesday, Oct. 25, Las Vegas |
| Business Valuation Overview | Wednesday, Sept. 20, LAX |
| Fraud: The New Audit Paradigm | Monday, Oct. 23, Las Vegas |
| Fraud: Exposures & Solutions in the Non-Audit Environment | Tuesday, Oct. 24, Las Vegas |
| Family Law Conference | Thursday, Oct. 26, LAX Friday, Oct. 27, SF |
| Family Law Practice: How & Why | Wednesday-Thursday Aug. 23-24, SF |

Asset

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Angeles-based accounting firm of Laffer & Gottlieb and its principals (Martin Laffer and Barbara Gottlieb) for their violation of an asset freeze order. ... In its contempt application as to the Laffer & Gottlieb accounting firm, the Commission alleged that, in connection with accounting services they provided to Herula and Capalbo in the Commission actions, the Laffer & Gottlieb firm, through Martin Laffer and Barbara Gottlieb, solicited and accepted fees in the amount of \$41,350 through credit card payments from Capalbo in September and October 2002. The contempt application

alleged that the payments to the Laffer & Gottlieb firm violated the May 2002 asset freeze order entered by the Rhode Island District Court against Capalbo."

The asset freeze order made no mention of credit card payments, lines of credit, loans or any similar types of payments. During the process of preparing a reply to the SEC's motion for civil contempt, our attorney asked if there was any accounting literature stating that a credit card is not considered an asset.

We contacted the AICPA's member hotline, but they responded that they were unable to provide us an answer. So we then called the AICPA general counsel's office to obtain an official AICPA response to present to

the court as evidence that a credit card is not an asset.

No Violation Found

After several discussions with the general counsel's office, the AICPA said it could not provide a declaration and stated that there were mixed opinions as to whether or not a credit card was an asset. When asked where the credit card would be reflected on a financial statement, they were unable to answer.

In the end, the Court determined that there had been no violation of the freeze order. The Court's citation for the factual determination was based on *Black's Law Dictionary* definition of a credit card: an identification card used to obtain items on credit, usually on a revolving basis.

Definitions in Webster's and Britannica reflect the same.

Despite the SEC's belief that a credit card is an asset, the Court determined that it is not.

Martin G. Laffer, CPA is a member of the Litigation Sections Steering Committee and a partner with Laffer & Gottlieb in Beverly Hills.

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