

The Witness Chair

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

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Corporate Investigations: “It Was the Best of Times, It Was the Worst of Times”

by Daniel W. Ray, CPA

“It was the best of times, it was the worst of times.” This famous opening line from Charles Dickens’ *A Tale of Two Cities* aptly describes today’s business environment. The extraordinary number and dollar magnitude of corporate scandals being uncovered nearly daily are juxtaposed with the opportunities afforded forensic accountants who provide corporate investigation services.

During the past several years, the public has been exposed to corporate and accounting scandals involving such stalwarts as Enron, Arthur Andersen, Adelphia, Tyco, and the mutual fund industry. Without oversimplifying the complex issues surrounding these debacles, the common denominator may be that those entrusted to ensure the accuracy and integrity of representations made in a variety of forums, most often through financial statements, may have failed to do their jobs.

This scandal-filled era is not the first time in U.S. history in which corporate officers, or seemingly entire industries, appear to be ethically challenged. The example that comes to mind is the savings and loan industry crisis of the mid-1980s. As a special agent with the FBI in Southern California during that time, I investigated numerous failed financial institutions. Today’s financial scandals are different in the following ways: 1) the dollar amounts of the losses are greater; 2)

the industries are more varied; 3) the frequency, or at least the reporting of allegations of such scandals, appears greater; and 4) public tolerance for such corporate hijinks has run out.

On the positive side, there is a tremendous opportunity for practitioners with the requisite skills, training, and experience in corporate investigations for providing such services. These opportunities may be greater now than during other periods of financial crises because: 1) Arthur Andersen’s collapse has narrowed the playing field; 2) the Sarbanes-Oxley Act of 2002 has shifted some of this work to smaller regional firms; 3) impacted shareholders, bondholders, and lenders demand such investigations; 4) the FBI’s ability to investigate allegations of white-collar crime is reduced due to the deployment of agents to homeland security and domestic terrorism assignments; and 5) the growth in forensic accounting and litigation consulting services.

Not too long ago, the public had never heard of forensic accounting. Nowadays, there appears to be a widespread understanding of this niche practice. About 18 months ago, I was asked by a local news station to comment about a jobs survey that identified forensic accounting as one of the fastest-growing careers in the country.

Corporate investigations typically employ many of the same techniques used in fraud investigations and other forensic accounting assignments. The

difference is that corporate investigations often are broader in scope. For instance, a fraud investigation typically involves analyzing a defined set of transactions for the purpose of determining whether indicia of fraud exist. A corporate investigation, however, may extend beyond allegations of fraud to include issues such as breaches of fiduciary duty or improper corporate governance. It attempts to answer questions such as: How did this happen? Did we as an organization properly respond? How can we prevent this in the future?

The usual impetus for a corporate investigation is an allegation or concern of an impropriety raised by a party in interest. The resulting investigation usually involves conducting a detailed review and analysis of the underlying accounting, banking, or other financial records to ascertain, with as much precision as possible, the true nature of the questioned transaction(s). Corporate investigations, however, often extend beyond an analysis of the business records.

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Section

ACTION

Business Valuation

by Ted D. Israel, CPA

After the papers are written and seminars concluded, our valuation theories remain just that—theories. That is, until they are tested in court. When the U.S. Tax Court (Court) or Court of Appeals rule in a case involving business valuation, the rulings frequently provide insight into the courts' disposition toward various valuation strategies and techniques.

Three 2003 gift tax cases involving family limited partnerships are gold mines of information for those performing estate and gift tax valuations: *McCord v. Commissioner*, 120 T.C. 358 (2003); *Lappo v. Commissioner*, T.C. Memo 2003-258 (9/3/03); and *Peracchio v. Commissioner*, T.C. Memo 2003-280 (9/25/03). Much has been written about these cases, including my more in-depth article in the January/February 2004 issue of *Valuation Strategies* titled "A Trio of Family Limited Partnership Cases," available at www.eckhoff.com. The following are general conclusions about developing discounts:

- There are no benchmark or automatic discounts for either minority status or lack of marketability. Experts must analyze surveys and draw inferences only from data that is comparable to the subject entity.
- Select and analyze sufficient data. In *McCord* and *Lappo*, the Court concluded that Petitioner relied on an insufficient number of REIT transactions to support the minority interest discount. The Court made it clear that it would rather draw inferences from a large amount of general data than a small amount of "comparable" data if it feels the data is not so comparable.
- The discount from net asset value observed in publicly traded REITs is

composed of both a liquidity premium and a minority discount. You must isolate and remove the liquidity premium to properly derive the minority discount.

- Be careful citing IPO studies in support of marketability discounts. The studies were rejected in *McCord*, and it is unclear if this will affect their usefulness in future cases.

Ted D. Israel, CPA, ABV, CVA is partner in charge of litigation services for Eckhoff Accountancy Corporation in San Rafael.

Economic Damages

by David W. Roberts, CPA

Those attending the Feb. 25 meeting benefited from three informative presentations.

Lynn Jones provided an in-depth look at the latest draft of the AICPA engagement letter practice aid and its impact on litigation services. Concerned about potential effects on litigation practitioners, the Litigation Sections has provided the AICPA with numerous comments. Jeff Kinrich, a co-author of the practice aid, added significant insight. The practice aid will replace Consulting Services Practice Aid 95-2, *Communicating Understandings in Litigation Services: Engagement Letters*.

Jeff Kinrich reviewed a draft of the AICPA's *Proposed Statement on Standards for Valuation Services*. Comments from the Litigation Sections have had a major impact in addressing significant concerns, flaws, and oversights. A revised draft is expected soon, with publication anticipated later this year.

Troy Dahlberg and Doug Farrow discussed changes in litigation consulting caused by pending AICPA restrictions and the Sarbanes-Oxley Act. Reasons for the growth in large boutique litigation consulting firms were explored.

New section officers were elected. The 2004-06 officers will be: Lynn Jones, chair; Colin Johns, vice chair; David Roberts, treasurer; and Chris Tregillis, secretary. We look forward to your participation

at our May 24 meeting at The Ritz-Carlton in Marina del Rey.

David W. Roberts, CPA, CIRA, CFE is the Economic Damages Section treasurer and a partner in the Insolvency and Litigation Department of Grobstein, Horwath & Company LLP in Sherman Oaks.

Family Law

by David S. Cantor, CPA

Contrary to accounting principles or economic reality, there is no family law case in California that definitively addresses the issue of accruing tax liabilities on all appreciated assets. This can create a conundrum for the forensic accountant when preparing valuations or even community property balance sheets.

In re Marriage of Fonstein [17 Cal.3d 738 (1976)] dealt with the issue of tax impacting husband's interest in his law practice. The California Supreme Court (Court) determined that there should be no tax liability when it stated, "Moreover, since there is no indication in the record that Harold is withdrawing, must withdraw, or intends to withdraw from his firm to obtain the cash with which to pay Sarane her share of the community property, there is no equitable reason for allocating to Sarane a portion of the tax liability which may be incurred if and when he does withdraw." In other words, the tax liability is not "immediate and specific." [*Marriage of Weinberg*, 67 Cal.2d 557 (1967)].

In re Marriage of Epstein [24 Cal.3d 76 (1979)] did allow for the accrual of a tax liability on a future event (the sale of the family residence). However, the Court clearly pointed out that this case differed from *Fonstein* when it stated "Unlike *Fonstein*, which involved a speculative future tax liability arising on the hypothetical sale of an asset, in the present case the taxable event, the sale of the residence, occurs as a result of the enforcement of the Court's order dividing the community property."

Message from the Chair

Other cases, such as *In re Marriage of Horowitz* [159 Cal.App.3d 368 (1984)], *In re Marriage of Nelson* [177 Cal.App.3d 150 (1986)], *In re Marriage of Harrison* [179 Cal.App.3d 1216 (1986)] and *In re Marriage of Sharp* [143 Cal.App.3d 714 (1983)] also deal with various potential tax liabilities. However, with the myriad of cases dealing (or not dealing) with potential tax liabilities of various assets, the accountant may want to confer with counsel, or consider presenting a dual approach that shows the effects on the asset(s) both with and without the tax impact.

David S. Cantor, CPA, ABV is the Family Law Section chair and a partner at Gurse, Schneider & Co. LLP in Los Angeles.

Fraud

by Ernest C. Cooper, CPA

One of the most productive and effective investigative techniques law enforcement uses in criminal investigations is confidential sources and informants. These sources are individuals who provide the investigator with valuable information or perform other lawful services under the investigator's direction.

Sources, along with the other six investigative techniques—interviews, background information, physical and electronic surveillance, undercover operations, laboratory analysis, and analysis of financial transactions—are the cornerstones of a successful investigation. It is the use of the source technique that fraud investigators, especially non-law enforcement investigators, sometimes overlook and underutilize during the course of non-criminal investigations.

There are three major categories of sources: professional sources, who usually want money in exchange for their service and information; defendant sources, who provide information in exchange for leniency on a crime with which they have been charged; and citizen sources, who typically have information about a certain event, transaction, or person and want to provide this information confidentially.

Citizen sources can provide direct

by D. Paul Regan, CPA

The Steering Committee held its annual meeting Jan. 21–23. We thank CalCPA liaison Maria Nazario for her usual spectacular job planning the event. Most important was the exchange of ideas and camaraderie enjoyed by the attendees. The agenda covered a number of issues that impact litigation services, including: 1) John Lacey's update on the future of the profession and litigation services, as well as his first "GAAP/GAAS Update" to this group; 2) the AICPA's *Proposed Statement on Standards for Valuation Services* (Proposed BV Standards); 3) the AICPA's engagement letter practice aid; and 4) a fantastic presentation on how to effectively cross-examine an expert by Roger Dodd, an attorney from Georgia.

As I reported previously, several Steering Committee and Business Valuation Section members have been pursuing changes to the Proposed BV Standards. Our efforts have focused on trying to convince the AICPA's Forensic and Litigation Services and Business Valuation

committees to recognize the need to significantly revise the document so its content would not be harmful to the litigation services practitioner but rather enhance our practice area. I am very pleased to report that our efforts have been successful. The AICPA is working to iron out the needed revisions so that the published standards can be a helpful tool for our litigation practitioners. Again, I applaud the passion and dedication that our volunteers have invested toward the goal of producing the best possible guidance for our profession.

This is my last *Message from the Chair* as my two-year term will soon end. It has been my privilege to serve our Litigation Sections. Our members are skilled and talented in their practice areas, and are outstanding CPAs who consistently adhere to CalCPA's core values. Be well my friends, and remember, let's be careful out there!

Paul Regan, CPA, CFE is president and chair of Hemming Morse Inc., CPAs, Litigation and Forensic Consultants in San Francisco.

information or investigative leads to further the investigation. They typically provide information that is not readily apparent from the results of other investigative techniques.

Citizen sources can be anyone in an organization, from an entry-level clerk to a high-level officer. They typically have firsthand knowledge about a transaction or person and have a motive to provide information.

Fraud investigators need to look out for indicators that someone may be able to provide confidential information, such as a disgruntled employee; a long-

time employee; a former associate, including an ex-spouse or significant other; or a Good Samaritan secretary. Be prepared to meet with citizen sources at any time.

During your investigation, pay attention to the person pouring coffee near you in the company's break room—they may be hovering intentionally in order to talk with you, and could be a key citizen source.

Ernest C. Cooper, CPA, CFE, JD, a former FBI special agent, is director of KPMG's Forensic Practice in Los Angeles.



Punitive Damages Studies: Post-Campbell

by Henry Stotsenberg, CPA

The courts are concerned about runaway juries awarding excessive punitive damages verdicts, and have lost confidence that punitive damages verdicts are reasonable and constrained. So, no matter how reprehensible the conduct, courts are reluctant to sustain large punitive damages verdicts. In the wake of the U.S. Supreme Court's decision last year in *State Farm Automobile Insurance Co. v. Campbell*, No. 01-1289 (*Campbell*), much discussion was raised about whether or not jury verdicts will be constrained to a single-digit multiple of the underlying compensatory damages in determining the amount of punitive damages. What does this mean to the economic expert? Does *Campbell* change the way an economic expert should conduct a punitive damages study?

Two Studies, Two Purposes

A punitive damages study is really a combination of two studies with separate purposes. One study is germane to the issue of the reprehensibility of the defendant's conduct, that is, the amount of punitive damages necessary to punish the defendant for wrongful conduct. The other study assists in determining the appropriate, most efficient, and rational level of punitive damages necessary to deter the defendant from repeating the wrongful conduct. Sometimes these studies overlap and are blended.

The economic expert can help determine the amount of punitive damages necessary to punish the defendant by opining on the rele-

vant financial indicators to assess the defendant's wealth. The wealthier the defendant, the more the defendant can afford to pay as punishment. Some financial indicators that can help determine the defendant's wealth include: net worth, including the expert's retro-structuring of net worth; defendant restructurings; the up-stream of cash to owners over the past few years; operating cash flow; operating income and loss; cash dividends; and surplus and excess surplus funds.

Reprehensibility

Because of *Campbell*, the old "reprehensibility" formula, meaning that you can sustain big punitive damages by showing extremely reprehensible conduct and substantial economic wealth, is being questioned. Whether the old formula is as effective as it had been pre-*Campbell* is for lawyers to argue. Counsel will need to advise the economic expert on just how relevant a reprehensibility punitive damages study is for each case in light of *Campbell* and how far and deep it should be conducted.

Deterrence

The effectiveness and relevance of a deterrence study is another matter. Limiting an award to a single digit multiple of the underlying compensatory damages designed to prevent awards that excessively punish the defendant may not be sufficient to deter the defendant from repeating a wrongful conduct. The dollar amount from a single digit multiplier may not be sufficient to get the attention of the defendant's board of directors and stockholders. It could be viewed as a cost of doing business.

The trial record in *Campbell* did not include an economic opinion regarding the requisite parameters for an effective and economically efficient award that would be necessary to deter the defendant from repeating its wrongful conduct. It seems, however, that economic logic is almost wholly involved with the deterrence aspect of punitive damages. The chal-

lenge of a deterrence study is to provide the economic guideposts and parameters that will assist the trier of fact in arriving at an award that is neither arbitrary nor speculative, but is economically efficient—an award that will deter the defendant from repeating wrongful conduct.

Economic logic indicates that the most relevant economic parameters come from a study that quantifies the gains and profits and avoided costs of the defendant from its wrongful conduct. Profits from the illicit conduct and costs that were saved by not instituting proper procedures to avoid the illicit conduct should be relevant to determining the punitive damages amount. The use of a reliable methodology is usually necessary to ascertain these gains or profits and avoided costs. In addition, quantifying the increased value of the key executives' incentive compensation plans resulting from the wrongful conduct also may be relevant.

These economic findings can be viewed against a backdrop of the defendant's thresholds for materiality and financial discomfort. A materiality threshold can be viewed as the highest dollar amount that would not be considered material to the financial condition of the defendant. With a lot of creative investigation and examination of defendant's records and public domain filings you can discover defendant's admissions and forensically establish the dollar amount that is material to the defendant's financial condition. Some examples of these records and filings include the defendant's financial statements, SEC filings, state regulatory filings, merger and acquisition documents, and financings and bank loan agreements. To the extent discovery permits, ascertaining the magnitude of items that were written off or discussed with auditors that were not considered material can help establish a materiality threshold.

In addition to materiality, thresholds can be established for what dollar amount, if paid, will or will not

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by Ann E. Wilson, CPA

The AICPA's Forensic and Litigation Services Committee (FLS) met recently in Newport Beach.

At the meeting, the following conferences were noted:

- AICPA/AAML National Conference on Divorce, May 13–14 in Las Vegas.
- AICPA Conference on Fraud and Advanced Litigation, Sept. 26–29 in Phoenix.
- Business Valuation Conference, Nov. 7–9 in Orlando.

The AICPA will retain the Accredited in Business Valuation (ABV) credential, currently held by 1,536 members. If a minimum of 2,700 credential holders is not achieved by the fiscal year ending July 31, 2008, the AICPA Board of Directors may sunset the ABV.

The Consulting Services Membership Section will be restructured and become the Business Valuation/Foren-

sic and Litigation Services Membership Section (Section). The Section should launch in late summer. A Section Executive Committee will be created to approve any proposed standards for business valuation and forensic and litigation services. Later in the year the Section will become part of the BV/FLS Quality Center.

FLS members can provide input for the type of deliverables and services that would benefit Section members. Deliverables will include news via the website, technical tools, and practice management tools. If you would like to see specific deliverables or benefits, such as practice aids on specific subjects, contact me at ann@aeWilsoncpa.com.

Ed Dupke, an author of the AICPA's *Proposed Statement on Standards for Valuation Services*, reported that based on the comments received from CalCPA and others, the latest draft is being rewritten and there will be an opportunity to comment on the revised draft before it is published.

The updated engagement letter practice aid and the new family law practice aid should both be available later this year.

The AICPA and the American Society of Appraisers (ASA) announced in November that ABV practitioners will receive full credit for the ASA's four courses and exams. An ABV still would have to complete the remaining ASA requirements to receive an Accredited Senior Appraiser credential (ASA credential). Meanwhile, CPAs who also hold the ASA credential will receive full credit for the ABV exam. CPAs who are also Certified Valuation Analysts or Certified Business Appraisers must take the morning portion of the ABV exam.

The AICPA and ASA will sponsor a joint national business valuation conference in 2005 in Las Vegas.

The Business Valuation Committee has appointed two liaisons to The Appraisal Foundation, the organization that promulgates the Uniform Standards of Professional Appraisal Practice (USPAP) and periodically reviews business valuation standards.

Ann E. Wilson, CPA, CFE is a member of the AICPA's FLS. She is a sole practitioner, with offices in Solana Beach and Pasadena.

Corporate Investigations

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The extensive use of two additional techniques is common: 1) interviews and 2) computer forensics.

Auditors have been required for some time now to conduct interviews with select key personnel during financial statement audits. This requirement recently was strengthened by *Statement on Auditing Standards No. 99*. Litigation practitioners are aware that on many occasions the facts surrounding the matter often are not on paper. The interview process is quite often a critical component of a corporate investigation. Great care should be taken to determine who should be interviewed, as well as the order and timing of the interviews. Specialized training on how to conduct interviews is available through a variety of professional organizations,

including CalCPA and the Association of Certified Fraud Examiners.

The recovery and review of electronic data may include correspondence, spreadsheets, e-mails, and instant messages. The files can be found in a variety of places, including the computer's hard drive or on the network and its back-up media. Critical information that previously was deleted also may be recovered through the use of computer forensics. These techniques, when employed by qualified professionals, have the potential to uncover compelling evidence. Qualified computer forensic professionals receive training from either a law enforcement organization, such as the Federal Law Enforcement Training Center, or from courses offered through a major university, such as the ones offered in partnership by New Technologies, Inc. and Oregon State University. Addi-

tionally, computer forensic software certifications, such as the EnCE (Encase Certified Examiner) offered by Guidance Software for their Encase product, are valuable qualifications.

Practitioners who conduct corporate investigations need to strike a delicate balance between being thorough and complete without violating the rights of those being investigated. Practitioners need to work closely with corporate counsel to ensure that Right to Financial Privacy Act and Fair Credit Reporting Act laws are followed. Furthermore, questions asked about particular individuals need to be phrased so as not to slander the subject of the investigation.

Daniel W. Ray, CPA, CFE, CIRA is a director in the Litigation Services Group of Hemming Morse, Inc., CPAs, Litigation and Forensic Consultants in San Francisco.



H A P P E N I N G S

Litigation Sections Meetings

Business Valuation	Thursday, May 6 Renaissance Parc 55 Hotel, SF Thursday, July 22, LAX Thursday, Sept. 16, North
Economic Damages	Monday, May 24 The Ritz-Carlton, Marina del Rey Wednesday, July 21, LAX
Family Law	Friday, May 7 Renaissance Parc 55 Hotel, SF Friday, July 23, LAX Friday, Sept. 17, North
Fraud	TBA

All Litigation Sections members are invited to the May BV and FL meetings.
Each section will send individual meeting notices.

Education Foundation Course Offerings—(800) 877-5897 or www.educationfoundation.org

Litigation Services Week

Litigation Consulting: Essential Skills for Staff and Others	Monday, Sept. 20, LAX
2004 Litigation Services Conference	Tuesday, Sept. 21, LAX
California Community Property	Wednesday, Sept. 22, LAX
Tax Consequences of Divorce	Thursday, Sept. 23, LAX
Family Law Workshop	Friday, Sept. 24, LAX

Valuation

Fundamentals of Business Valuation Part I	Mon.–Wed., July 26–28, SF
Fundamentals of Business Valuation Part II	Mon.–Wed., Aug. 23–25, SF
Business Valuation Overview	Thursday, July 1, San Jose Friday, Oct. 1, SF
ABV Exam Review	Friday, Oct. 29, OC South

Keepin' It Legal

Continued from Page 4

cause financial discomfort to the defendant. Findings regarding financial discomfort can take several different forms, most of which involve examination of the defendant's past financial transactions. Examination of these transactions usually will enable the economic expert to

forensically determine the defendant's financial discomfort level. Examples can involve the examination of the defendant's dividend policy over the last few years, a variety of arrangements for up-stream cash to a parent company, management fee deals with a parent and affiliates, special dividend payouts, restructurings, special deals with affiliated companies, stock (owner-

ship) buy backs, and unique or special key executive compensation arrangements.

The expert can provide the trier of fact with economic parameters that are reliable and not speculative, and based on solid, relevant, and reliable data and information. This appeared to have been missing in the *Campbell* case.

Henry Stotsenberg, CPA is managing owner of Stotsenberg Consulting, a forensic and investigative accounting firm based in Murrieta with major engagements throughout the United States.

Editor's Note: The California Supreme Court recently granted review of two cases, *Simon v. San Paulo U.S. Holding Company (Simon)* and *Johnson v. Ford (Johnson)*, involving awards of punitive damages. In *Simon*, the 2nd District Court of Appeal upheld an award in excess of the single-digit multiple, while in *Johnson*, the 5th District Court of Appeal reduced an award to a 3-to-1 multiple.

The Witness Chair is published quarterly by the Litigation Sections of the California Society of Certified Public Accountants.

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