

A Case Study of the Role of the Forensic Accountant in a Legal Dispute

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Abstract

With increasing frequency, forensic accountants are called upon to play important roles in resolving legal disputes ranging from civil actions such as breaches of fiduciary duty to Racketeer Influenced Corrupt Organizations (RICO) Act criminal violations involving gambling, arson for profit, extortion, securities fraud, and mail fraud. In any litigation, the forensic accountant's role is to examine the financial issues relevant to the case, summarize and explain those issues to interested parties (e.g. the judge, attorneys and plaintiffs/defendants), and offer expert testimony in court, if necessary. Ultimately, the opinions of the forensic accountant must be presented in a written report that will be reviewed by the opposing parties in the dispute as well as by the judge likely to hear the case. Thus, the report supplies the basis for pre-trial settlement negotiations and in-court testimony if the case does not settle. The report's strength (or lack thereof) also influences the opposition in deciding whether to settle out of court or to 'fight' the matter in court. Consequently, the forensic accountant's report is vital to the successful resolution of a legal dispute. The purpose of this paper is to illustrate the importance and significance of the forensic accountant's report using an actual report that prompted the successful settlement of a \$1.7 million lawsuit. The paper also suggests an overall organization to such a report. Together, these illustrations will provide academics with access to an actual forensic accountant's report for purposes of instructing students in the development and use of such reports, as well as a basis for preparing such reports as opportunities to participate in similar cases arise. Suggestions for using the case as an instructional tool are provided in an appendix.

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Introduction

Recent accounting frauds such as those involving Arthur Andersen, Dynegy, Enron, Global Crossing, K-Mart, Merck, Qwest, Tyco, WorldCom, and Xerox and numerous others have wiped out tens of billions of dollars in shareholder value and has placed forensic accounting and forensic accountants in the spotlight more than ever before. A feature story from U.S. News & World Report described forensic accountants as “the bloodhounds of bookkeeping [who] sniff out fraud and criminal transactions in corporate financial records.” The story listed the “forensic accountant” as the first of “eight of the nation’s most secure career tracks” (Levine, 2002). Statement on Auditing Standard (SAS) Number 99—Consideration of Fraud in a Financial Statement Audit and the Sarbanes-Oxley Act of 2002 are forcing companies to more aggressively seek out fraud. Boards of directors are demanding that forensic accounting become part of corporate governance and of financial reporting. Consequently, top accounting firms predict forensic accounting services to increase by as much as 50% (Iwata, 2003).

An increasingly common service provided by forensic accountants is the preparation of reports that summarize and defend the findings of a forensic engagement in which they have been involved. Such reports play an important role, not only in the completion of forensic engagements, but also in subsequent litigation. Few, if any, examples of such reports based on real-world fraud examinations are available. The purpose of this paper is to help fill that void by explaining both the importance and significance of the report itself, and to present an example of such a report derived from actual litigation involving a RICO¹ violation. The expert report was used to successfully resolve a \$1.7 million lawsuit. The next section provides necessary background by examining the role of the forensic accountant in a legal dispute.

¹ The RICO statute was originally enacted in 1970 to fight organized crime’s infiltration of legitimate business; however, its powerful criminal and civil provisions have come to be used in a wide range of fraud cases. The statute outlaws the investment of ill-gotten gains in another business enterprise, the acquisition of an interest in an enterprise through certain illegal acts, and/or the conduct of the affairs of an enterprise through such acts. Under RICO, private individuals may recover three times their actual loss, plus attorneys’ fees, for economic damages caused by a violation of the statute.

Role of the Forensic Accountant in a Legal Dispute

With increasing frequency, forensic accountants assist attorneys in litigation involving matters such as financial frauds, embezzlements, misappropriation of funds, arson for profit, bankruptcy fraud, deceptive accounting practices, professional negligence, and tax evasion. Such assistance typically takes one of two forms: consulting expert or testifying expert. Both types of experts provide background information for developing litigation strategy, prepare written opinions, advise on depositions, and respond to discovery requests. Accordingly, they review documents, transactions, and other financial records to: (1) uncover the details of any defalcation, (2) establish responsibility for it, and (3) estimate losses incurred as a result of the defalcation. However, the consulting expert typically is much closer to the matter under dispute and has a much deeper understanding of it than does the testifying expert. For example, the consulting expert may know of fraud theories for which no corroborating evidence could be found whereas the testifying expert will only learn of the successful fraud theories. As long as consulting experts do not testify in court and are engaged directly by the attorney, their work product is protected by attorney-client privilege and is not subject to discovery by the opposition (Babitsky et. al., 2000).

The testifying expert performs many of the same functions as the consulting expert but also provides expert testimony in court. Before testifying in court the testifying expert must first be ‘qualified’ or accepted by the court as an expert witness. To establish their expertise to the judge and jury, testifying experts respond to questions concerning their professional credentials, which typically encompass education, work experience, licensing or certification, technical training, books and journal articles written, offices held in professional associations, awards and commendations received. Since many legal disputes become a battle of expert witnesses, it is advantageous to engage an experienced testifying expert with strong professional credentials. After being qualified, the testifying expert must educate the jury by: (1) establishing the facts, (2) interpreting the facts, and (3) commenting on the opposing expert’s facts and opinions (ACFE, 2003). Since the work product of testifying experts is subject to discovery by the opposition, attorneys will not provide them with information they do not want discovered by the opposition.

Forensic accountants may be engaged by the plaintiff/prosecution, defense, or by the court to educate the judge about fraud-related matters relevant to the matter under dispute. Each of these roles demands certain prerequisites and logistics in terms of the forensic accountant's

skill set but also in terms of the relevant tasks that they must accomplish. For example, forensic accountants must understand and have the ability to properly document and report the findings resulting from their investigative efforts. When serving as a testifying expert, such documentation becomes even more important as the opposing parties will scrutinize, in minute detail, the content of such a report seeking material for rebuttal, contradiction, and embarrassment. Hence, the expert report is an extremely important document that merits attention in the literature.

The Expert Report

In most cases, experts must document their opinions and the evidence underlying them in a written report. Such expert reports may be required for a variety of reasons. First, a written report may be required by the court pursuant to Federal Rule of Civil Procedure 26(2)(B). Second, the expert report may provide the script for the expert's testimony in court. Third, the expert report may be used to counter a *Motion for Summary Judgment*² or to discourage the opposition from demanding a costly deposition of the expert. Finally, a well-written and soundly reasoned report may prompt the opposition to concede during out-of-court settlement negotiations. Whatever the reason, the expert's report plays a crucial role in resolving legal disputes and should be carefully drafted (Babitsky, 2000).

The Association of Certified Fraud Examiners offers the following suggestions for preparing an effective expert report (ACFE, 2003):

- Be brief.
- Avoid ambiguity, inexact language, or technical language.
- Avoid generalizations; be specific.
- Add charts or graphs where appropriate.
- Reference your work.
- Meticulously check the report for accuracy and neatness.

When preparing the expert report, keep in mind that the opposing counsel will carefully scrutinize the report looking for anything that might diminish the expert's credibility in the eyes

² A pre-trial *Motion for Summary Judgment* can be made by either side in a civil dispute. Such a motion petitions the judge to decide the case, without a trial, based on the evidence in the plaintiff's complaint and the defendant's answer. The motion is granted unless either side disputes the facts as presented by the other side.

of the court. The following case study illustrates the role of the forensic accountant in a legal dispute as both a consulting expert and a testifying expert. In addition, the related expert report (see Exhibit 2) exemplifies many of the characteristics of effective expert reports.

A Case Study of a Legal Dispute³

Background

For over 25 years Thomas Burns had owned and managed a number of successful restaurant franchises located in the Upper-Midwest and Canada. He had a reputation as an aggressive businessman who delegated to others the day-to-day operations of his various business ventures. Thomas had been especially successful at selecting and purchasing ideal restaurant locations before the local real estate market recognized and charged a premium for those locations. However, he rarely put much of his own money at risk in these business ventures, but preferred to finance these ventures with other people's money. In his spare time Thomas had obtained a private pilot's license and purchased a 1992 Piper Seneca III that he used for both business and leisure purposes. With the consent of his tax accountant, he wrote off the entire \$358,000 cost of the aircraft as a business expense.

Regarding his personal life, Thomas was married with two children who, after graduating from Ivy-league universities, had moved to Southern California to establish professional careers. Thomas and his wife enjoyed living a comfortable, even extravagant, lifestyle. They lived in a beautiful home, drove expensive cars, dined at the finest restaurants, and frequently took vacations to exotic places. In addition, they generously shared their wealth with their children and friends. Rumor had it that Thomas kept exactly \$100,000 cash stashed in a safe in his home "for a rainy day" and enjoyed showing it to visitors.

Lou Erickson was a retired businessman who had spent 30+ years of his career in upper-management positions at Fortune 500 corporations. He knew most, if not all, of the accounting tricks that were used to put a 'positive spin' on financial statements. Consequently, he did not trust the stock market and chose not to invest there. Instead, Lou preferred to create and invest in business ventures that he had carefully selected and researched and then let others run the

³ The names of investigators, forensic accountants, plaintiffs, defendants, and related entities have all been changed to preserve confidentiality. For additional background details, see the *Appendix* for a factual summary of the case as prepared by plaintiff's attorneys.

business. In early 1995 Lou invited several friends and former business associates to a social at his home. After some mingling and socializing, Lou presented a business proposition to them: Open two new locations of the popular “Franchise Restaurant” chain that was distinguished not by its food but instead by the attractive, scantily-clad young women it hired to serve the predominantly male clientele. The start-up costs for the two ventures would be about \$1.75 million. Lou proposed setting up two limited partnerships to finance the start up costs of the restaurants, one of which would be located in Minnesota and the other in Canada. Based on financial information provided by the franchisor, Lou estimated that the limited partners should recover their investments in less than five years. A general partner would need to be selected to manage the day-to-day operations of the two restaurants. The proposition was favorably received and two people suggested Thomas Burns as a potential general manager. Lou offered to approach Thomas about the proposition.

Lou scheduled a business lunch with Thomas for the following week. During the lunch, Lou presented his business proposition and invited Thomas to be the general partner. Unbeknownst to Lou or any of the prospective limited partners, Thomas was having serious cash flow problems caused by a combination of his extravagant lifestyle and some ill-chosen restaurant ventures that were consuming large amounts of his cash. Lou’s business proposition came just in time to rescue Thomas from his deteriorating financial situation. Consequently, Thomas readily accepted the proposition and agreed to make the minimum 1% investment (i.e. \$17,500) legally required of general partners in limited partnerships. Eight limited partners, including Lou, agreed to invest \$216,562 each to complete the financing to start up the two restaurants.

In March of 1996 Thomas Burns created a corporation that he named Flying High, Inc. to act as the General Partner in the Limited Partnerships that would own the two Franchise Restaurants. He also selected MTC, Inc., a restaurant management company owned and managed by him, to manage the finances of the two restaurants and appointed Alan Kirk to be the general manager of both. After much pre-opening publicity and fanfare, the two restaurants opened and for the first two years attracted better-than-expected numbers of customers. However, despite strong restaurant traffic, the restaurants failed to generate positive cash flow available for distribution to the limited partners. Instead, to cover the restaurants’ losses, the limited partners were periodically issued “cash calls” that required them to invest more money

into the restaurants with the promise that things would improve shortly. Contrary to the provisions of the partnership agreement, the limited partners were not provided financial statements or any financial information to justify the need for the cash calls. Understandably dismayed, the limited partners demanded financial statements so they could evaluate how their substantial cash investments were being managed. MTC, Inc. was contractually responsible for producing the financial statements but consistently stonewalled numerous requests by the limited partners for financial statements. Consequently, the dissident limited partners, led by Lou Erickson, filed a civil lawsuit against Thomas Burns and related parties claiming mail and wire fraud and violations of the Racketeer Influenced Corrupt Organizations (RICO) statute. Exhibit 1 presents a visual diagram of the various parties involved in the legal dispute.

Resolving the Legal Dispute

To assist in resolving the dispute between the dissident limited partners and Thomas Burns, the plaintiffs' attorneys engaged the professional firm Woodruff & Associates, LLP, a firm that specialized in fraud detection, investigation, and prevention consulting services. The firm then assigned Bill Benson, a certified fraud examiner and retired federal agent, to work as a consulting expert on the case. Mr. Benson first met with the attorneys and the limited partners to develop a strategy for collecting and examining the documents and financial records needed to resolve the allegations under dispute. Subsequently, Mr. Benson organized and examined over 28,000 documents and identified 20 incidents of fraud in a written report to plaintiff's attorneys. The consulting firm then assigned Winston Woodruff—a partner in the firm who possessed a Ph.D. and was a certified public accountant (CPA) and a certified fraud examiner (CFE)—to serve as the testifying expert for the case. Dr. Woodruff met with the attorneys and Mr. Benson, and carefully reviewed Mr. Benson's report along with relevant supporting documentation. Dr. Woodruff then prepared an expert report summarizing and defending his opinion concerning the financial issues under dispute (see Exhibit 2). The rationale for using two different experts in this case is twofold. First, as a consulting expert engaged directly by the attorneys, Mr. Benson's work product and extensive involvement in the case was protected by the attorney-client privilege and was not discoverable by the defendant's attorneys. Second, Dr. Woodruff's extensive academic and professional credentials greatly enhanced his credibility as a testifying expert. Moreover, since Dr. Woodruff was expected to testify in court, his work product and

involvement in the case were discoverable by the opposition. However, Dr. Woodruff's limited involvement in the case effectively shielded much information from being discovered by the other side.

Trials substantially increase the litigation costs of the parties caught up in a legal dispute. Consequently, few civil lawsuits ever go to trial. Most cases either settle prior to trial or are otherwise disposed of through pretrial motions (Kramer & Connolly, 2005). Thus, the expert report will most likely be used to motivate the other side to reach a favorable out-of-court settlement. Perceived weaknesses in the expert report can have at least two outcomes detrimental to the client: (1) the other side might decide to go to trial expecting that they can win by exploiting the weaknesses, or (2) the other side might exploit the weaknesses to settle for a lesser amount. In the lawsuit against Thomas E. Burns, the expert report was a major factor in negotiating a favorable out-of-court settlement. After reviewing the expert report in preparation for pre-trial settlement negotiations the judge declared to the plaintiffs, "You have valid fraud claims, and if this goes to trial, you will win." The financial details of the subsequent settlement were kept confidential, even from the forensic accountants who worked as expert witnesses on the case.

Conclusion

Forensic accountants are increasingly being called upon to provide litigation support services. In a legal dispute, the forensic accountant's role is to examine the financial issues relevant to the case, summarize and explain those issues to interested parties (e.g. the judge, attorneys and plaintiffs/defendants), and offer expert testimony in court, if necessary. Ultimately, the findings and opinions of the forensic accountant must be presented in a written report that will be reviewed by the opposing parties in the dispute as well as by the judge likely to hear the case. Thus, the expert report provides the basis for pre-trial settlement negotiations and in-court testimony if the case does not settle. The strength of the expert report (or lack thereof) directly influences the opposition in deciding whether to settle out of court or to 'fight' the matter in a trial. Consequently, the forensic accountant's expert report is vital to the successful resolution of a legal dispute.

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Exhibit 1

WOODRUFF & ASSOCIATES, LLP

SPECIALIZING IN FRAUD DETECTION, INVESTIGATION, AND PREVENTION CONSULTING SERVICES

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7874 East Superior Road
Richland, IN 48267-2934

MEMO

To: Richard Robertson, Lead Prosecutor
From: Winston A. Woodruff, Ph.D., CPA, CFE
Date: January 22, 2002
Subject: Expert report regarding litigation against Thomas E. Burns

Background

Accounting is an information system that identifies, records, and communicates the financial events of an enterprise to interested users. The objectives of financial reporting⁴ are to provide:

- information that is useful in investment and credit decisions,
- information that is useful in assessing cash flow prospects, and
- information about enterprise resources, claims to those resources, and changes in them.

To satisfy the above three objectives, a single set of general-purpose financial statements is prepared. These statements are expected to present fairly, clearly, and completely the financial operations of the enterprise. To ensure that financial statements are fairly and accurately presented, the accounting profession has developed standards or rules that should be universally applied. These standards and procedures are called generally accepted accounting principles (GAAP). The term “generally accepted” means either that an authoritative accounting rule-

⁴ “Objectives of Financial Reporting by Business Enterprises,” *Statement of Financial Accounting Concepts No. 1* (Stamford, Conn.: FASB, November 1978), pars. 5-8.

making body has established a principle of reporting in a given area or that over time a given practice has been generally accepted because of its universal application.

To understand the importance of having generally accepted “rules” for financial reporting, consider the importance of generally accepted rules in a sport such as football. Without rules, football would be a chaotic mass of confusion. One team might field twenty players while the other only fields ten. One team might award themselves ten points for scoring a touchdown while the other might only award six. One team might condone “facemasking” while the other does not. Without rules, there would be no way to determine whether a team is cheating or which team won the game. Clearly, generally accepted rules are necessary to ensure “fair play” and to be able to determine who won or lost the game.

Without accounting rules, financial reporting would be a chaotic mass of confusion. One business might decide to record sales when the customer agrees to buy and another might decide to record sales when cash is collected. One business might value its property, plant, and equipment at historical cost while another does it at fair market value. One business might reduce the value of its investments to market value while others do not. Without accounting standards, investors, creditors, or other users of accounting information would have an extremely difficult time understanding the substance of a given set of financial statements. Without accounting rules, it would be difficult to determine whether management and employees of a business have “cheated” by diverting some profits to their own pockets and the cost of capital would skyrocket. Clearly, accounting rules are necessary to ensure “fair play” and to provide investors and creditors with fair and accurate information for making investing and lending decisions.

Those charged with managing the day-to-day operating activities of a business have a fiduciary duty⁵ to know, and to play by, the “rules” for identifying, recording, summarizing, and communicating financial information. Further, management has a fiduciary duty to establish an accounting system that safeguards business assets from employee theft, robbery, and unauthorized use.

Expert Witness Conclusions

⁵ Management owes certain duties imposed by law to the owners of the business. The principal fiduciary duties are loyalty and care.

Bill Benson—a senior investigator of Woodruff & Associates, LLP—prepared an investigative report dated November 30, 2001 that presents evidence regarding the formation, operation, and management of Northern Lights Investment Limited Partnership (Northern Lights) and Midwestern Lights Investment Limited Partnership (Midwestern Lights) by Flying Sly, Inc. (Flying Sly) through Thomas Burns; Rochelle Bowman; Vivian Bowman; William Richardson; and Vernon Frankl; MTC, Ltd.; Eastern Lights Ltd.; and Western Wings Investment Limited Partnership during the period November 1995 to January 1999. After reviewing Mr. Benson’s investigative report that is based on the information available to date, I have formulated opinions that are based on a reasonable degree of academic and professional certainty. Accordingly, it is my opinion that the following investigative findings constitute either violations of generally accepted accounting principles or breaches of fiduciary duty:

1. Economic Entity Assumption Violations

The economic entity assumption presumes that the boundaries among economic entities be clearly drawn and maintained such that the activities of a given entity be accounted for separately and distinctly from the activities of all other economic entities. Limited Partnership shares are registered securities, governed by the terms of the Partnership Agreement. The economic entities relevant to this dispute are as follows:

- Northern Lights Investment Limited Partnership (Northern Lights)
- Midwestern Lights Investment Limited Partnership (Midwestern Lights)
- Flying Sly, Inc. (Flying Sly)
- MTC, Ltd.
- Eastern Lights Ltd.
- Western Wings Investment Limited Partnership
- Domestic Beef Company
- Everett Crawford

Regarding the above entities, note that Northern Lights and Midwestern Lights are separate and distinct limited partnerships. Several limited partner investors are common to both partnerships, but not all. The remaining entities are all owned and/or controlled by Thomas Burns. Regardless, the boundaries among the entities must be drawn and maintained such that a proper accounting between each entity and its environment can be effected.

In my opinion, which is based on a reasonable degree of academic and professional certainty, the following investigative findings constitute a blurring of the boundaries among what are supposed to be separate and distinct entities. In essence, violations of this generally accepted accounting principle known as the economic entity assumption:

a. Timothy Benning, P.C. Invoices

Northern Lights paid the legal fees and costs necessary to incorporate Flying Sly, Inc. Since Flying Sly—which is wholly owned by Thomas Burns—is a separate economic entity from Northern Lights, this violates the economic entity assumption. Accordingly, any monetary transfers from Northern Lights to Flying Sly that are not authorized by Northern Lights limited partners constitute misappropriations of partnership assets.

These payments also violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.”

b. Impoundment Agreements

Funds collected from the limited partners to finance the start up costs of the two restaurants were subject to the provisions of an Impoundment Agreement as required by the State Securities Commission. Such an agreement requires that the invested funds be first deposited into an escrow account until all of the funds needed have been collected, after which the funds are released. Since the impoundment agreements were between Northern Lights and State Bank and Midwestern Lights and State Bank, upon termination of the impoundment agreements the funds should have been deposited into separate Northern Lights and Midwestern Lights bank accounts pursuant to the specific written instructions of the State Securities Commission. Instead, Thomas Burns deposited the funds into a Flying Fly checking account at State Bank. Since Flying Sly—wholly owned by Thomas Burns—is a separate economic entity from Northern Lights and Midwestern Lights, this violates the impoundment agreement, state securities laws, and the economic entity assumption. Accordingly, any funds deposited into a Flying Sly checking account constitute a misappropriation of partnership assets.

These deposits violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.”

c. \$109,000 Wire Transfer to Trenton, Indiana

In April 1997, Rochelle Bowman wire transferred \$109,000 from the Flying Sly, Inc. checking account at State Bank to Trenton, Indiana to finance the construction of a restaurant (i.e. Domestic Beef) being built by Thomas Burns. No receivable was ever established on the books of Midwestern Lights. Since the only funds in the Flying Sly checking account at the time were Midwestern Lights investor funds and the restaurant was a separate economic entity owned by Thomas Burns and others not partners in Midwestern Lights or Northern Lights, this violates the economic entity assumption. Since Flying Sly—wholly owned by Thomas Burns—is a separate economic entity from Midwestern Lights, this violates the economic entity assumption. Accordingly, the \$109,000 wire transfer constitutes a misappropriation of partnership assets.

This transaction violates Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.” In addition, it violates Section 4.3, Part (ii) of the Partnership Agreement, which specifically prohibits the lending of “any assets of the Partnership to or guarantee any obligations of the General Partner, as Manager.”

d. Commingling-Flying Sly and Northern Lights/Midwestern Lights

Funds received by both Northern Lights and Midwestern Lights from the sale of the unauthorized Canadian calendars, nylons, uniforms, and gift certificates were deposited into Flying Sly checking accounts. Since Flying Sly—wholly owned by Thomas Burns—is a separate economic entity from Northern Lights and Midwestern Lights, this violates the economic entity assumption. Accordingly, any such funds deposited into Flying Sly checking accounts should be considered a misappropriation of partnership assets.

These deposits violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.”

e. Payments to Bernard Macintosh

Legal costs incurred in 1997 by defendants for the establishment of a Crimson Rose Restaurant were paid for with Northern Lights funds and never repaid by Calgary. Since the Crimson Rose Restaurant is a separate economic entity from Northern Lights and Midwestern Lights, this violates the economic entity assumption. Accordingly, any legal costs related to the Crimson Rose paid for with Northern Lights funds should be considered a misappropriation of partnership assets.

These payments violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.”

f. Crimson Rose Restaurant

During 1998, Midwestern Lights and Northern Lights assets including things such as gift certificates, dolphin shorts, golf shirts, tee shirts, booster seats, tracksuits, employee lockers, and calendars were transferred to the Crimson Rose Restaurant. Since these asset transfers were not approved by the Midwestern Lights and Northern Lights investors and the Crimson Rose Restaurant is a separate economic entity from Midwestern Lights and Northern Lights, this violates the economic entity assumption. Accordingly, any such unauthorized transfers of assets constitute misappropriations of partnership assets.

Vernon Frankl and William Richardson were both paid full-time salaries as employees of Northern Lights yet “spent a lot of time working on the Crimson Rose.” Justine Wilson stated that “Crimson Rose Restaurant and the calendar occupied about 60 percent of Richardson’s time.” Such activities were not approved by, nor did they benefit, Northern Lights investors. Since the Crimson Rose is a separate economic entity from Northern Lights, this violates the economic entity assumption. Accordingly, a misappropriation of partnership assets has occurred when Vernon Frankl and/or William Richardson were working at the Crimson Rose while they were full-time employees of Northern Lights and Midwestern Lights.

These transactions and activities violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.” In addition, such

activity violates Section 4.3, Part (ii) of the Partnership Agreement, which specifically prohibits the lending of “any assets of the Partnership to or guarantee any obligations of the General Partner, as Manager.”

2. Related Party Disclosure Violations

Statement of Financial Accounting Standards (SFAS) No. 57 entitled “Related Party Disclosures”⁶ defines related parties as including transactions between “an enterprise and its principal owners or management” (paragraph 1). Accordingly, all transactions between Midwestern Lights or Northern Lights and any of the entities owned or controlled by Thomas Burns (e.g. Flying Sly, MTC, Ltd., and the Crimson Rose restaurant) should be considered related party transactions. The substance of such transactions should be examined carefully since the requisite conditions of competitive, free-market dealings do not exist (paragraph 15) and one party has an advantage over the other and can manipulate the terms of the transaction. Statement of Financial Accounting Standard No. 57 requires that the following disclosures be made with respect to related party transactions (see paragraph 2):

- The nature of the relationship involved.
- A description of the related party transactions.
- The dollar amounts of the related party transactions.
- Amounts due from or to related parties.

In his review of the books and records of Midwestern Lights and Northern Lights, Senior Investigator Bill Benson found evidence demonstrating lack of compliance with the above requirements.

All of the economic entity assumption violations discussed in Part 1 involved related party transactions. Accordingly, in my opinion, each of them can also be considered violations of SFAS No. 57 since the required disclosure information was not provided.

⁶ “Related Party Disclosures,” *Statement of Financial Accounting Standards No.57* (Stamford, Conn.: FASB, March 1982).

3. Basic Accounting Equation Violations

Assets are the resources owned by a business. Liabilities are the existing debts and obligations of a business. Owner's equity represents the ownership claims on total assets. The most fundamental of all generally accepted accounting principles is that the relationship of assets, liabilities, and owner's equity can be expressed by the following equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The Balance Sheet is a financial statement that reports the assets, liabilities, and owner's equity of a business at a particular date. Total assets must equal total liabilities and owner's equity. If all financial transactions occurring during a given period are recorded properly by the accounting personnel, the balance sheet should "balance"; that is, total assets should equal total liabilities and owner's equity. That a balance sheet should "balance" is an extremely basic principle of accounting. On behalf of both Midwestern Lights and Northern Lights, Thomas Burns entered into an agreement with MTC, Ltd.—wholly owned and managed by Thomas Burns—to manage both restaurants. Consequently, MTC personnel (e.g. Rochelle Bowman and Vivian Bowman) were responsible for the accounting systems for both Midwestern Lights and Northern Lights. The following investigative findings constitute basic accounting equation violations:

a. Midwestern Lights Balance Sheets Do Not Balance

The Balance Sheets for Midwestern Lights (Midwestern Lights) do not balance for four accounting periods during 1997, and one during 1998. Specifically, Total Assets are less than Total Liabilities and Partnership Equity for the following periods:

<u>Accounting Period</u>	<u>Amount of Discrepancy</u>
4/30/97	\$36,021.63
5/30/97	\$37,580.26
6/30/97	\$35,937.78
9/30/97	\$17,215.75
3/31/98	\$13,207.02

The fact that the Balance Sheets for Midwestern Lights do not balance for five accounting periods indicates that: (1) the MTC personnel do not possess the requisite knowledge and skills to competently record and report accounting information, and/or (2) the out-of-balance conditions are the result of employee/management defalcations or impropriety.

b. \$44,000 Wire Transfer to U.S. Checking

On July 16, 1997 \$23,271.12 of Midwestern Lights cash funds were used to pay off a personal line of credit (i.e. State Bank loan number 451584) in the name of Thomas Burns. The withdrawal can be found on the July 1997 bank statement from State Bank. However, no entry is made in the accounting records to reduce the cash balance by \$23,271.12. Consequently, the cash balance per books was falsely stated as being more than the cash balance per the bank statement. This violation of generally accepted accounting practice caused the accounting equation to be “out-of-balance.”

The purpose of the overstatement in the cash account balance was to “cover up” the fact that \$109,000 of Midwestern Lights investors’ funds had been wire transferred to benefit the construction of Thomas Burns’ restaurant in Trenton, Indiana. Since the financial activities of Midwestern Lights should be kept separate from the personal financial activities of Thomas Burns, this violates the economic entity assumption. Accordingly, any Midwestern Lights funds used to pay for the construction of Thomas Burns’s restaurant in Trenton, Indiana constitutes a misappropriation of partnership assets.

This GAAP violation violates Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.”

c. Errors in the Accounting Records

The Benson report lists 61 different errors and/or irregularities in the accounting records of both Midwestern Lights and Northern Lights including things such as:

- Account category amounts not adding up to the general category totals.

- Accounts in the inventory section of the balance sheet being left off one month and then reappearing in later months.
- Ledger balances maintained by MTC do not equal the amounts reported on the Balance Sheet.
- Ending cash balances for one month do not equal the beginning cash balances for the next month.
- Accounting entries made without any supporting documentation.

In my opinion, the existence of so many errors and/or irregularities in the accounting records indicates that: (1) the MTC personnel do not possess the requisite knowledge and skills to competently record and report accounting information, and/or (2) the accounting errors and/or irregularities are the result of employee/management defalcations or impropriety.

4. Breaches of Fiduciary Duty⁷

Persons in a position of trust or fiduciary relationship, such as officers, directors, high-level employees of a business, owe certain duties imposed by law to their principals or employers. The principal fiduciary duties are loyalty and care.

Duty of loyalty. Requires that the employee/agent act solely in the best interest of the employer/principal, free of any self-dealing, conflicts of interest, or other abuse of the principal for personal advantage. Thus, corporate directors, officers, and employees are barred from using business property or assets for their personal pursuits.

Duty of care. A corporate officer, director, or high-level employee must conduct business affairs prudently with the skill and attention normally exercised by persons in similar positions. Fiduciaries who act carelessly or recklessly are responsible for any resulting loss to the business shareholders or other principals.

Thomas Burns, as the general partner responsible for managing both the Midwestern Lights and Northern Lights franchises, owed a fiduciary duty to the limited partners who invested money in the franchises. In my opinion, the following

⁷ Source of information: *Fraud Examiners Manual, Third Edition (2000)*. The Association of Certified Fraud Examiners. Austin, Texas.

investigative findings constitute breaches of fiduciary duty owed by Thomas Burns to the limited partners.

a. *Franchise Options—Northern Lights*

Thomas Burns failed to apprise the Northern Lights limited partners of the cost and time sensitivity of the franchise options purchased by Northern Lights through Flying Sly. Consequently, franchise options costing \$30,000 were either allowed to expire or were improperly transferred. Such acts constitute breaches of the fiduciary duties of care and loyalty owed by Thomas Burns to the limited partners of Northern Lights.

This failure violates Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.” In addition, it violates Section 10.3, Part (b) which prohibits the General Partner from “sell(ing) or otherwise dispos(ing) of Partnership property without first obtaining the approval of at least fifty-one percent (51%) in aggregate investment interest of the Limited Partners,” and Part (c) which prohibits the General Partner from “possess(ing) Partnership property or assign(ing) its rights in specific Partnership property for other than a Partnership purpose.”

b. *General Partner 1% Contributions*

Flying Sly, Inc.—wholly-owned by Thomas Burns—failed to make the required initial 1% General Partner capital contributions on a timely basis as required by law in connection with both the Northern Lights and Midwestern Lights franchises. Flying Sly, Inc. made its “contribution” using funds to which it was not entitled. Such an act constitutes a breach of the fiduciary duty of loyalty owed by Thomas Burns to the limited partners of both Northern Lights and Midwestern Lights.

This breach violates Section 6.1 of the Partnership Agreement, which states that “the General Partner will make an initial Capital Contribution in cash in an amount equal to one percent (1%) of the aggregate Capital Contributions of the Partners on the date this Amended Certificate and Agreement of Limited Partnership is filed as required by law.”

In addition, Thomas Burns and Rochelle Bowman presented Lee Otteson, a limited partner of both Midwestern Lights and Northern Lights, with a false document in an effort to establish that Burns had made his 1% General Partner capital contribution in Midwestern Lights. Such an act clearly constitutes a premeditated effort to deceive the limited partners and a breach of the fiduciary duty of loyalty owed by Thomas Burns to the limited partners of both Northern Lights and Midwestern Lights.

c. MTC, Ltd. Management Agreement

Thomas Burns, as President of Flying Sly, entered into a Management Agreement with his wholly-owned corporation MTC, Ltd. to manage the Garnett Rose restaurant (Northern Lights). The agreement was not made at “arms length”⁸ and grants MTC, Ltd. expenses in excess of the 5% management fee as set forth in the management agreement. Such an act constitutes a breach of the fiduciary duty of loyalty owed by Thomas Burns to the limited partners of Northern Lights.

This breach violates Section 4.2, Part (h) of the Partnership Agreement, which requires the General Partner “to engage accountants...and any and all other agents and assistants...and to compensate them in such reasonable degree and manner as may be necessary or advisable.”

d. \$100,000 Flying Sly Loan – Midwestern Lights / False Entries

To further disguise the fact that \$109,000 of Midwestern Lights investor funds had been diverted to finance the construction of another restaurant being built by Thomas Burns in Trenton, Rochelle Bowman “created a false and misleading summary for activity in the Flying Sly account” which corroborates an alleged loan from Flying Sly to Midwestern Lights. However, no loan agreement or any other documentation has been found which corroborates the existence of the alleged loan. Rochelle Bowman later claimed that \$100,000 represented a “loan from Flying Sly to the Trenton Domestic Beef” that was partially paid

⁸ An “arm’s-length” transaction is one in which competitive, free market conditions exist (see SFAS No. 57, paragraph 3). Accordingly, for the agreement between MTC and MWI/CWI to be considered “arm’s length” it should have similar terms and fees to competing property management companies.

back. At least four deposits cited by Rochelle Bowman as being loan repayments from the Domestic Beef were in fact received from sources other than the Domestic Beef. Rochelle Bowman's own accounting for the alleged loan indicates that \$44,202.39 was never paid back. Such efforts by Rochelle Bowman to conceal from Midwestern Lights investors the \$109,000 unauthorized transfer of Midwestern Lights funds clearly constitute a premeditated effort to deceive the limited partners and a breach of the fiduciary duty of loyalty owed by both Rochelle Bowman and Thomas Burns to the limited partners of Midwestern Lights.

These efforts violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits "any assets of the Partnership to become commingled with the assets of the General Partner as Manager." In addition, it violates Section 4.3, Part (ii) of the Partnership Agreement, which specifically prohibits the lending of "any assets of the Partnership to or guarantee any obligations of the General Partner, as Manager."

e. \$51,418.49 Pay to MTC – Midwestern Lights / False Entry

The November 1997 Midwestern Lights General Ledger includes an entry whereby \$51,418.49 is debited to "Payable to MTC" and credited to "U.S. Checking." However, no documentation exists to corroborate this entry nor do any payments from the "U.S. Checking" account correspond with this entry. Accordingly, the entry is completely false as no payment was made to MTC. Such an act constitutes a breach of the fiduciary duty of care owed by Thomas Burns to the limited partners of Midwestern Lights.

f. Winnipeg (Midwestern Lights) Rent Guarantee

Thomas Burns received ten times the rent guarantee to which he was entitled. According to the partnership agreement, Thomas Burns was entitled to receive \$960 under the rent guarantee, not the \$9,600 he actually received. Such an act constitutes a breach of the fiduciary duty of loyalty owed by Thomas Burns to the limited partners of Midwestern Lights.

g. Northern Lights Girls Calendar

All activities associated with the development and distribution of the Northern Lights Girls Calendars constitute breaches of the fiduciary duties of loyalty and care owed by Thomas Burns to the limited partners of both Northern Lights and Midwestern Lights. The fiduciary duty of care was violated since the creation of the calendar constituted a breach of the Restaurants of America franchise agreement, thus exposing the limited partners to possible litigation by Restaurants of America. Ultimately, the calendars—whose creation had been financed by Northern Lights and Midwestern Lights—were transferred to Flying Sly without reimbursing Northern Lights and Midwestern Lights for the costs of creating the calendars. Such an act constitutes a breach of the fiduciary duty of loyalty owed by Thomas Burns to the limited partners of both Northern Lights and Midwestern Lights.

These breaches violate Section 4.3, Part (iii) of the Partnership Agreement, which specifically prohibits “any assets of the Partnership to become commingled with the assets of the General Partner as Manager.” In addition, such activity violates Section 10.3, Part (b) which prohibits the General Partner from “sell(ing) or otherwise disposing of Partnership property without first obtaining the approval of at least fifty-one percent (51%) in aggregate investment interest of the Limited Partners,” and Part (c) which prohibits the General Partner from “possess(ing) Partnership property or assign(ing) its rights in specific Partnership property for other than a Partnership purpose.”

Summary Opinion

The Association of Certified Fraud Examiners defines fraud as follows:

“Fraud includes an intentional or deliberate act to deprive another of property or money by guile, deception or other unfair means.”

In my opinion, which is based on a reasonable degree of academic and professional certainty, in an effort to deprive the Limited Partners “of property or money by guile, deception or other unfair means,” Thomas Burns, et al., deliberately and intentionally, violated numerous generally accepted accounting principles, violated numerous provisions of the Partnership Agreements,

violated state securities laws, misappropriated partnership assets, and breached the fiduciary duties of care and loyalty he owed to the Limited Partners.

Submitted by:

Winston Woodruff

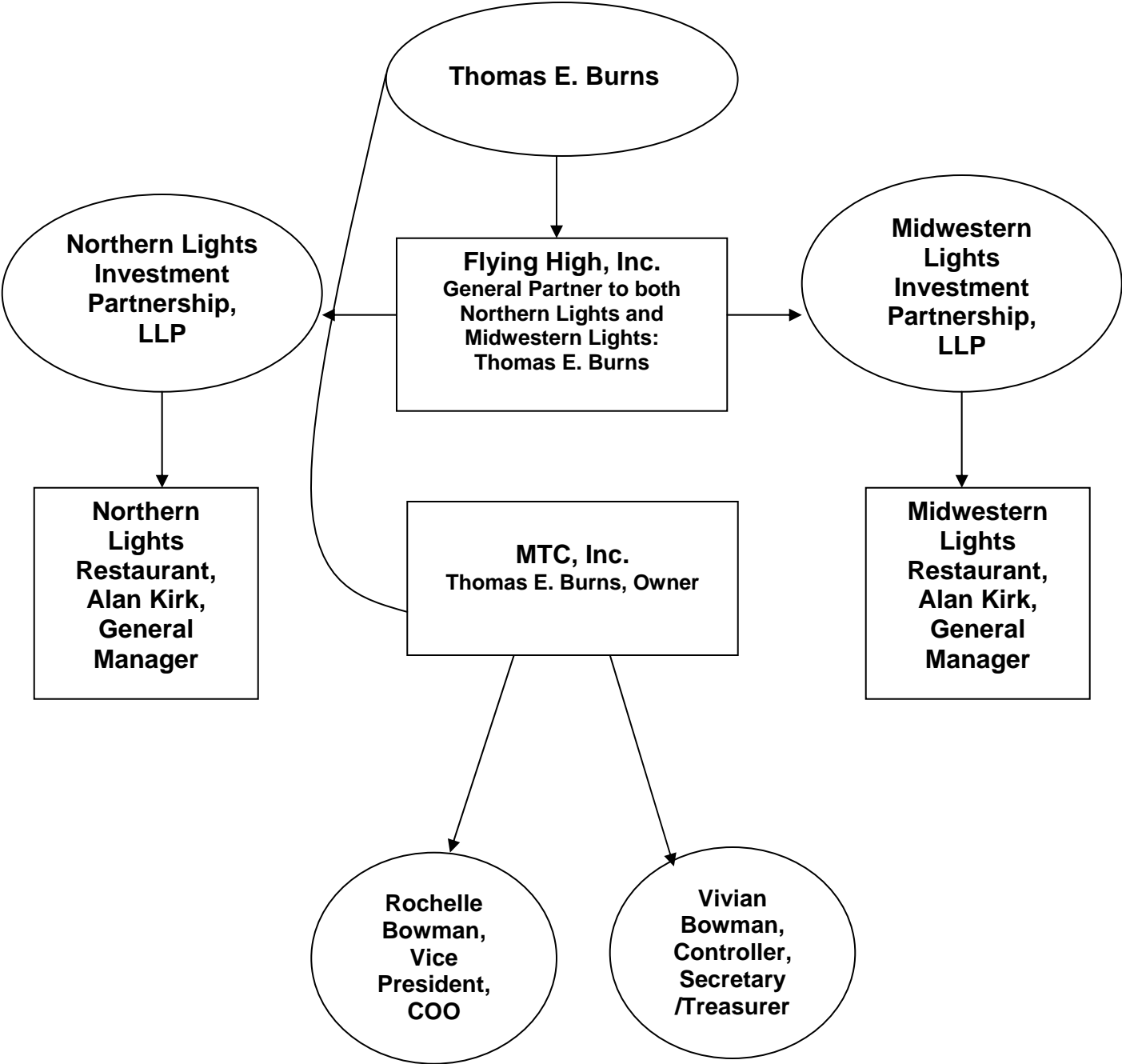
Winston Woodruff, Ph.D., CPA, CFE

Chief Executive Officer

Woodruff and Associates, LLP

Exhibit 1

Diagram of Parties Involved and Relationships in the Thomas E. Burns Case



Appendix I

Factual Overview Prepared by Plaintiffs Attorneys

Players: The defendant in this dispute is Thomas E. Burns. Thomas Burns is the owner and president of MTC, Ltd., a restaurant management firm, which had been established over 25 years earlier. MTC is an important element of this case and served as the “enterprise” as required under the RICO⁹ statute. Burns had hired two sisters, who were long-time associates of Burns to serve as other officers of MTC. Rochelle Bowman is Vice-president, and responsible for day-to-day operations; Vivian Bowman is Controller and Secretary/Treasurer. The Bowman sisters are co-defendants in this legal dispute. Burns and his co-defendants had used MTC Burns to manage numerous restaurants in both the United States and Canada.

The plaintiffs in this dispute are majority interest investors in two limited partnerships, Northern Lights Investments (Northern Lights) and Midwestern Lights Investments (Midwestern Lights). Northern Lights and Midwestern Lights were formed to develop some vacant commercial property in the United States and Canada into two restaurant franchises. The Northern Lights and Midwestern Lights investors knew of Thomas Burns’ restaurant management firm, MTC, Inc., and approached him about becoming a general partner in both Northern Lights and Midwestern Lights. Burns anticipated that the two restaurant franchises would be very successful, and in March 1998 Burns formed Flying Sly, Inc., a US business corporation solely to act as the General Partner in the Northern Lights and Midwestern Lights Limited Partnerships. Exhibit 1 graphically summarizes the relevant parties involved in this litigation.

Acting for Flying Sly as General Partner, Burns engaged his own corporation, MTC, Ltd. to manage the Franchise Restaurants owned by Northern Lights and Midwestern Lights. Each of these limited partnership owns a ‘Franchise’ Restaurant; Northern Lights owns a Franchise Restaurant located in the United States and Midwestern Lights owns a Franchise Restaurant located in Canada.

⁹ The Complaint makes a claim of a Racketeer Influenced Corrupt Organizations violation under Title 18 U.S. Code Section 1962(c) that states: It shall be unlawful for any person employed or associated with an enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise’s affairs through a pattern of racketeering activity or collection of unlawful debt.

The capitalization of Northern Lights was approximately US \$1.0 Million cash from the limited partners. That capitalization served as the basis for calculating partner distributions. The capitalization of Midwestern Lights was approximately US \$0.75 Million cash from limited partners. The total amount entrusted to Thomas Burns, the General Partner for both Northern Lights and Midwestern Lights, was approximately US \$1.75 Million.

Burns, as Flying Sly General Partner, engaged his corporation, MTC, Ltd. to manage the two Franchise Restaurants owned by Northern Lights and Midwestern Lights. Given the clear conflict of interest on Burns's behalf, the resulting contract was not arms-length. Notwithstanding, Rochelle Bowman and Vivian Bowman were responsible for the "bookkeeping" for the Franchise Restaurants. Neither of the Bowman sisters had any academic or professional training in accounting. Rochelle graduated from State University with a major in English and Vivian had some college education but no degree.

Specific Allegations of Fraud

Commingling of Funds. Defendant Burns, doing business as Flying Sly, Inc., together with the Bowman sisters, gained exclusive control over all partnership funds following initial deposit of the investment funds. Unbeknownst to the plaintiffs, Burns and the Bowman sisters immediately began diverting and commingling those funds with their separate non-partnership funds from other non-related restaurants and corporations which Thomas Burns and the Bowman sisters controlled. Using the Flying Sly account under his personal control, Burns then improperly commingled corporate and personal funds with partnership funds which continued until a majority of the limited partners removed Burns as the General Partner of Northern Lights and Midwestern Lights on October 26, 2000. Subsequently, Burns further "borrowed" approximately US \$300,000 in partnership funds that he transferred to a non-partnership restaurant called Domestic Beef.

"Bootleg" Calendars. Burns had hired defendant Alan Kirk to act as regional manager of both Franchise Restaurants. While serving in that managerial position, Kirk, with instructions and the knowledge of Burns and Rochelle Bowman, began creating unauthorized swimsuit, pin-up-type calendars utilizing the financial resources of both Franchise Restaurants and featuring some of the restaurant employees. Since the franchisor created and sold similar calendars through franchisees, such calendars violated the franchise agreement. That agreement

specifically prohibited franchisees from creating and selling calendars that compete with the franchisor's own products. The evidence further indicates that monies of both Franchise Restaurants were used to front the expenses of calendar production and were also used to sell the calendars. Further, rather than maintain the proceeds from calendar sales of nearly US \$500,000 as part of the assets of the two restaurants; they were diverted to bank accounts controlled exclusively by Thomas Burns.

Plaintiff's Investigation

The evidence supporting the Plaintiff's claims developed from an ongoing forensic accounting inquiry beginning in December 2000, and conducted by certified fraud examiners through Woodruff & Associates, LLP whose examiners include lead examiner Winston Woodruff, and Bill Benson. Exhibit A contains a copy of Plaintiff's expert Winston Woodruff's report of accounting irregularities.

Specific allegations of wrongdoing by Thomas Burns include securities law irregularities, commingling of limited partnership funds with Burns's personal funds, and various allegations of fraud. The foundation for all of the fraud allegations is the fiduciary duty, including duties of loyalty and care, owed by General Partner Thomas Burns to the limited partners of Northern Lights and Midwestern Lights. Hallmarks of the multi-tiered, complex scheme to defraud are categorized in over 20 areas of intentionally deceptive accounting practices, commingling and unlawful use of limited partnership funds, various cover-up tactics (including false statements to the limited partners), false entries in the books and records of the partnerships, and misappropriation of partnership funds into bank accounts controlled by Burns and his co-defendants.

Forensic accounting experts organized and reviewed over 28,000 documents. Expert Winston Woodruff asserts that the books and records of the limited partnerships' two Franchise Restaurants (i.e. Northern Lights and Midwestern Lights) were intentionally manipulated to facilitate and conceal the fraudulent schemes being perpetrated by Burns and his co-defendants. A non-exhaustive description of some 20 "badges" of fraud developed by certified fraud examiner Bill Benson are set out in a report which serves as the foundation for Woodruff's report.

Plaintiff's Damages

The Plaintiffs contend that direct economic damages totaling US \$1.3 Million resulted from the Defendants wrongful acts and omissions. As of May 1, 2002, Plaintiffs have incurred or paid to the forensic accounting firm of Woodruff & Associates, LLP, approximately \$175,000 for its services. Additionally, Plaintiffs have incurred or paid approximately \$250,000 to legal counsel for services rendered in this matter. Thus, Plaintiff seeks \$1.725 Million in damages, which if a RICO claim is proved will be trebled according to law.

Appendix II

Suggestions to Academics for using the Case as an Instructional Tool

As noted in the text of this case study, the contents are based on an actual case. Accordingly, the content is useful as an instructional tool in forensic accounting classes. For example, we use the case to illustrate (1) the complexities that surround real world cases, diagramming the important relationships in a real world case as an aid to understanding, (3) the importance of the expert witness report, and (4) preparation/analysis of the expert witness report. Accordingly, we suggest the following as an assignment, in whole or in parts.

Instructions to students:

1. Read pages 1 to 9 of the case, and the information in the Fraud Examiners Manual (or other material provided by instructor) on Expert Witness Reports.
2. Based on the information found in the section “A Case Study of Legal Dispute”, prepare a chart depicting the important relationships discussed in the section.
3. Prepare a Factual Overview of the Case to be used by Plaintiff’s Attorney’s as an overview of the major points of background and findings for the court (instructors see Appendix I).
4. Analyze the Expert Report in light of suggestions of the ACFE, and by discussion which parts of the report are apparently the most difficult to construct and require the most judgment, those that are rudimentary, and feel free to include suggestions for changing the report.
5. This case, like most was actually settled out of court. Discuss reasons why the majority of cases settled out of court.

The instructor could assign all or part of these and/or additional instructions to be prepared in groups. Further, the instructor might assign a group to shoot holes, as it were, in the case prepared by the plaintiff.