

WALWORTH & NAYH, P.C.

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- Property & Casualty Insurance Claims Consulting
- No-Fault / Wage Loss Claims Consulting
- Litigation Support
- Training and Seminars for insurance, legal and accounting industry professionals

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Watch for "Red Flags" in the Books and Records

In commercial property claims, thoughtful review of an insured's books and records can lead to the detection of "red flags" that indicate an increased likelihood of fraud, or potentially significant overstatement of a claim. This doesn't necessarily require financial wizardry, but it does necessitate diligence coupled with critical thinking.



Comparing data sources

Comparing and contrasting information contained in summary reports with underlying records may turn up discrepancies that shouldn't be there. For example, sales reported on income tax returns should agree to sales tax returns and financial statements. These, in turn, should agree to underlying sales journals and general ledgers. They need not (and probably won't) agree to the penny, but should be relatively similar for a given time period. Significant discrepancies between these documents may indicate that "summary level" reports have been altered to present a more favorable financial picture. Requesting the full range of "summary level" reports down to source documents makes it much more difficult for someone who is intent on providing misleading "summary level" information.

Tax returns – a wealth of information

By themselves, business income tax returns contain a variety of potentially useful information beyond income and expense numbers. A corporate income tax return will generally include information such as:

- When the corporation was formed.
- Whether this is its first or last year of operation.
- The basis of accounting used (cash, accrual or some other method).
- The names and Social Security numbers of the owners.
- Whether the corporation owns any other corporations, or is itself owned by another corporation.

- Whether a foreign person owns 25% or more of the corporation.
- The year-end inventory value.
- The age and original cost of property, plant and equipment and (if a depreciation schedule is requested) a listing of the major fixed assets.
- Whether any significant assets have been sold.

If any of this information is as at variance with representations made by the insured, this would certainly be a "red flag" indicating the need for further investigation.

Ascertaining trends

Comparing several past years of tax returns can give a quick read on the overall financial health of the business. Key observations with potentially negative implications would include:

- A generally decreasing sales trend, particularly if decreasing with acceleration.

"Red Flags" continued on page 3

W & N CPAs awarded CFF Certification by the AICPA

In 2009, all of the partners and managers of Walworth & Nayh were awarded the Certified in Financial Forensics (CFF) Credential by the American Institute of Certified Public Accounts (AICPA). The CFF Credential, established in 2008 by the AICPA, is granted to qualified CPAs with considerable professional experience in financial forensics. Those awarded the CFF Credential (with their years of forensic accounting experience) are:

- Bob Walworth – 25 years
- Gary Nayh – 22 years
- Greg Wood – 20 years
- Mark Stephanic – 27 years
- Paul Donnan – 24 years
- Carla Kaschinske – 14 years
- Joe Lothschutz – 24 years
- Nick Mouzarakis – 7 years

"Awarded" continued on page 2

Verifying Tax Returns – have they been filed?

If you have ever been provided tax returns and wondered if they were actually filed with the Internal Revenue Service (IRS), then wonder no more. The IRS has a couple of different forms that may be of assistance to you and your investigation. These forms allow you authorization to obtain information on the tax returns or even copies of the actual returns on file with the IRS. These authorization forms are known as Form 4506 and Form 4506-T.

Transcripts

Form 4506-T allows you to obtain a transcript of the tax return. You will not be provided a copy of the actual tax return, however, the transcript can still be useful. It will summarize certain tax information for a particular year, such as gross income, adjusted gross income, taxes owed, etc. It will not provide detailed information such as a breakdown of wages earned from various employers or indicate which taxpayer actually received the wages. It does provide sufficient information if the objective is to merely confirm that the tax return you were provided was actually filed with the IRS. Although there is a limitation as to the information provided on the tax transcript, it is free of charge and is quicker to obtain than a copy of the actual return itself.

Tax Returns

Form 4506 allows you to obtain a complete copy of the actual tax return filed with the IRS. This is generally necessary in situations involving self-employed individuals when you need to know the detail of individual business expenses, which taxpayer earned the self-employment income, etc. Of course, there is a charge for obtaining actual copies of the

returns. Currently, the charge is \$57.00 for each year requested and payment is required upon submission of the request. Requesting a copy of the actual tax return itself does take more time for the request to be processed. In our experience, that wait could be anywhere from 30-90 days.

Both the forms 4506 and 4506-T can be obtained on our website, www.walnay.com. Just go to the site and click on the "Tools & Resources" button to download the forms.

What to do

Remember that these forms are authorizations from your claimant allowing you to obtain information from the IRS on their behalf. It is suggested that you fill in as much information on the request form as possible, including claimant's name, spouse's name, mailing address, Social Security number(s), etc. Be sure to place your name and mailing address in box 5 since you want the information from the IRS sent back to you directly and not to your claimant. Then mail the authorization to your claimant and have them sign, date and return the form back to you. You in turn forward the authorization on to the IRS, including a check or money order if necessary.

The key is for you to control this form and insure that the information is sent directly from the IRS to you. If the IRS is unsuccessful in locating the returns requested, you will be notified in writing and your money will be refunded.

These forms can be useful tools in your investigation process. If you are unsure of which form to use in your specific case, please feel free to contact any associate of Walworth & Nayh at (734)464-8990 for further discussion.



"Award" continued from page 1

All of our partners and managers met the requirements to earn the CFF credential, which include demonstrating significant business experience in the area of financial forensics (our CFF's average 20 years of forensic accounting experience) as well as completing a minimum of 75 hours of life-long learning and education activities in the area of financial forensics.

The CFF Credential is granted exclusively to CPAs who are members in good standing of the AICPA, which binds them to the AICPA Code of Professional Conduct. CPAs who have earned the CFF Credential must be recertified every three years to maintain their credential.

The CFF Credential designates our professionals and our firm as a premier forensic accounting service provider. It demonstrates our commitment to continuously improving forensic accounting skills and expertise, resulting in increased professional competency. These factors demonstrate the high level of skill, specialized expertise and experience that we bring to bear for our clients.



"Red Flags" Continued from page 1

- Significant net losses, particularly if they are getting worse over time.
- Significant negative net worth (liabilities greater than assets), particularly if it is getting larger over time.
- A trend of increasing officer compensation or dividends to owners if any of the above conditions are present. This may suggest intent to "drain" the business before it goes under.
- Large and sudden changes in the gross profit margin (gross profit divided by sales). The gross profit margin is generally relatively stable over time in most industries.
- Footnote attachments that disclose significant fines or penalties (these are not deductible for tax purposes, but would need to be disclosed in order to reconcile taxable income to the books).
- Expense items or footnote attachments that indicate prior claims, significant litigation or other problems.

Verifying tax returns

There are situations in which it may be advisable to request income tax returns directly from the IRS. This may be done to replace records that have been destroyed in a loss, or if you suspect that the tax returns being provided may not be true copies of what was filed with the government. The request is easily made. It requires only an executed copy (the insured must sign) of IRS Form 4506 and payment of a small fee. However, be aware that it may take up to 60 days for the IRS to respond, so it is best to start the process as soon as there is any indication that it may be necessary (see the article on page 2 regarding requesting tax returns from the IRS).

Looking at payroll

Review of payroll records may disclose other "red flags." Quarterly federal and state payroll tax returns should be consistent with each other, as well as the underlying payroll journals. Comparing payroll tax returns and payroll journals over time may also yield valuable information. Observations that may be "red flags" include:

- Additional personnel added to the payroll just before, or after, a loss.
- Significant increases in compensation and/or bonuses for owners or individual employees just before, or after, a loss.
- A dwindling employee roster over time.
- Unusually high turnover, particularly if it is accelerating over time.

Any of these conditions suggests the need to ask questions and conduct further investigation for the reasons behind the condition.

Looking for the unusual

There may be situations where you believe something isn't right, but can't quite put your finger on it. Here is an actual "audit procedure" as it would be written in an auditor's work program: "scan the general ledger and check registers." It doesn't sound highly technical and it isn't. What are you looking for? Anything unusual that stands out from routine, day to day transactions. Examples:

- Large and/or frequent payments to a law firm. This may be indicative of serious legal problems beyond everyday business matters.
- Payments to multiple accounting firms within a single year. This may be indicative of problems with the books and records.
- Large or unusual adjusting entries in the general ledger dated prior to the date of loss. Adjusting entries are not the direct result of a receipt or expenditure. They merely reclassify, or shift, amounts from one accounting category to another. A "red flag" example would be an adjusting entry that reclassifies a significant amount from repairs and maintenance expense to the inventory asset account just prior to the date of loss.
- Preloss capitalization (recorded as an asset) of items that should normally be expenses, followed by a postloss write-off (via depreciation or amortization expense, or an adjusting entry) of the asset in order to show it as a continuing expense in the period of restoration. An example would be capitalizing advertising expense that was incurred prior to a loss and then reclassifying it as an expense during the period of restoration.
- Large and/or unusual asset purchases just prior to the date of loss.
- A surge in recorded expenses just after a loss, particularly if the insured is on the cash basis of accounting. This may be indicative of an attempt to record past due bills (expenses that were actually incurred prior to the loss) in the period of restoration.

Source documents – some things to look for

Source documents provided in support of a claim may also indicate various "red flags." Here are some things to watch for:

- When checks are presented as evidence of payment, look for the stamps of the clearing bank and Federal Reserve on the back to verify that it has actually been negotiated. If you are provided with a copy, look for the imprint of the amount of the check on the lower right corner on the front. If it is not imprinted with the check amount, it probably has not been negotiated.
- When presented with a stack of invoices and receipts, scan through them to be sure the stack doesn't include multiple copies of the same invoices.
- When presented with photocopied documents, look them over for any signs that they may have been altered or fabricated. This includes things like: typefaces that do not match; misaligned type; lines that appear in odd places (indicating the original may have been folded to obscure information); or smudges and stray marks that continually appear in areas of key information like dates and amounts.

These are just a few observations that will hopefully be useful to you and illustrate the general type of thinking behind forensic accounting. While the presence of "red flags" does not necessarily mean there is actual fraud or overstatement, they do serve to indicate when it is more likely to be beneficial to conduct further investigation.

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At Walworth & Nayh, P.C., we specialize in Forensic Accounting Services, including Insurance Loss Accounting and Litigation Support.

We regularly provide expert testimony in deposition, trial and alternative dispute resolution venues. Our forensic specialists apply their knowledge of accounting, finance, information technology, and business to the investigation of specific issues related to insurance claims and litigation matters. Opinions are developed by thorough analysis combined with judgment and experience.

Our clients include insurance companies and their adjusters, private companies who have experienced a loss, and attorneys representing both plaintiffs and defendants involved in business disputes.

Unlike traditional accounting firms, we are exclusively devoted to helping clients resolve disputes by providing technical expertise in the relevant accounting and damages issues.

For further information, we invite you to contact one of our partners at the numbers listed above, or by e-mail at amoceri@walnay.com.

Firm News

Amy and Greg Partaka welcomed the arrival of their daughter Avery Janelle Partaka on November 5, 2008. This is Amy and Greg's first child.

We would like to welcome our newest associate, Nicolas Pump. He is a graduate of Oakland University with a degree in accounting and finance. He has several previous years of general public accounting experience and obtained his CPA license in 2008. After work, Nick's interest turns to sports, especially basketball and hockey.

EVENT CALENDAR

Gary Nayh and Greg Wood will be presenting seminars at two industry conferences this fall. On September 22nd, they will be discussing the wage loss implications of Ross v. ACIA at the National Society of Professional Insurance Investigators (NSPII) conference at the MSU Management Center in Troy. They will also present a seminar on "Wage Loss Claims in the Current Economic Climate" at the International Association of Special Investigation Units (IASIU) annual conference at 11:00 a.m. on October 14th at the Schoolcraft College Vis TaTech Center in Livonia.

Bob Walworth and Kurt Meyer will be presenting "Business Interruption: Cooking the Books for Profit – The Detection, Investigation and Litigation of Fraudulent Business Income Claims" at the National Society of Professional Insurance Investigators (NSPII) annual conference in Columbus, Ohio on November 16th and 17th.