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THE CASE FOR THE FORENSIC ACCOUNTANT
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A LOOK AT PONZI SCHEMES

Suddenly, Ponzi schemes seem to be everywhere.

Credit for the renewed attention to this classic financial fraud is of course due in large measure to Bernard Madoff, the now-convicted financier who defrauded investors of an estimated $65 billion. Madoff's widely publicized crime was a classic Ponzi – he took on investor funds, diverted them to finance his own lifestyle, falsified his clients' financial statements to show investment positions when there weren't any, then used new investments to pay "dividends" and "interest" to past investors. It was the largest and most dramatic example of a Ponzi scheme to date.

Ponzi Schemes are Widespread in Financial Downturns

But it's not the only one garnering attention. In fact, Ponzi schemes are gaining more widespread attention and being investigated by the FBI. Consider the following federal statistics:

- The FBI opened more than 2100 securities fraud investigations in 2009, up from 1750 in 2008. The FBI also had 651 agents working in 2009 on high-yield investment fraud cases, which include Ponzis, compared with 429 last year.

- The SEC, in 2009, issued 82 percent more restraining orders against Ponzi schemes and other securities fraud cases this year than in 2008, and it opened about 6 percent more investigations. Ponzi scheme investigations now make up 21 percent of the SEC's enforcement workload compared with 17 percent in 2008.

- The Commodity Futures Trading Commission filed 31 civil actions in Ponzi cases in 2009, more than twice the 2008 amount.

Ponzi schemes happen more often – and are exposed more often – in financial bubbles. As the bubble grows, investors seek ever higher yields, and their healthy skepticism takes a backseat to their enthusiasm. Then, when the bubble bursts, investors rush to withdraw their capital. But the capital is, of course, long gone, and therefore the schemes are exposed. In the wake of the financial meltdown, many Ponzi schemes came to light that otherwise might have remained undetected.

The Red Flag for a Ponzi Scheme is an Investment that Performs Too Well

How do you know if you or your client is involved in one? And what do you do about it? Attorneys, investment advisors and business leaders would do well to remember the old bromide that things that seem too good to be true, usually are. An investment, whether it's yours, your organization's or your client's, is suspect when it produces a much higher than normal yield, or that behaves in too predictable a way – for example, producing steady income with no fluctuations. That was the case with the Madoff funds, which outperformed the market in a manner that was unnaturally consistent.

A Forensic Accountant is an Essential Member of the Investigating Team

If you are involved in a Ponzi scheme, as an investor, an investment advisor, or an advocate, your best course would be to bring a forensic accountant to the table. Why is this? How can a forensic accountant help? While the investigation of a Ponzi scheme is often led by law enforcement officials, or by lawyers

and bankers concerned about their and their client's assets, ***the detection of the scheme itself can be a highly demanding, highly technical matter, and that's where forensic accounting excels***.

Cash Flow Analysis is Central to Detecting the Scam

In a typical Ponzi scheme, investors are led to believe that they are investing in high-yield financial instruments. But there are no such investments. The first evidence that investments are not what they seem – that they are not, in fact, being made – is usually revealed in cash flow analysis. Forensic accountants, who are skilled in tracing cash flow, are the professionals best qualified to trace the movement of funds into and out of the offender's bank accounts. This cash flow analysis is often used by attorneys to establish exactly how the offender received and depleted the victims' funds, and to determine the total amount that's been stolen.

Forensic Accountants "Follow the Money"

Tracing what actually happened to the funds is arduous work. Forensic accountants "follow the money" – they reconstruct the scheme by first obtaining all relevant banking records - checks, deposit slips, and monthly bank statements from the banking institutions in which the scammer placed the victims' funds. The bank deposits make each investment a traceable transaction – funds can be tracked from investor to scammer to the scammer's bank, then back to earlier investors, or into the scammer's pockets. The accountant then prepares a cash flow statement demonstrating the flow of funds received and disbursed from the scammer's bank accounts.

A cash flow analysis of the relevant bank accounts can clearly show that the victims' funds were never invested at all. The results of the forensic cash flow analysis are critical to the investigation. Often forensic accountants are called as expert witnesses, since the cash flow analysis can be used in court to demonstrate how the scammer committed the crime and spent the victims' funds.

Forensic Accounting Rounds Out the Investigation

Ponzi schemes are often challenging to investigate. There are usually multiple victims, often from multiple jurisdictions, and tracing out the details of the scam can quickly become time-consuming and costly. Involving a forensic accountant to provide analysis means that attorneys can be more efficient in their investigations and can provide the court with a highly detailed, concrete record of the crime. An investigating team that includes a forensic accountant is a complete team, and attorneys and investors should be sure that a skilled forensic accountant is on hand whenever a Ponzi scheme investigation gets underway.

ABOUT THE AUTHOR

Sareena M. Sawhney, MBA, CFE, CFFA, is a Senior Manager in the MP&S Litigation and Corporate Financial Advisory Services Group.

Ms. Sawhney provides forensic accounting services as well as services related to commercial litigation and economic damages. Ms. Sawhney has consulted on breach of contract, fraud, tracing of assets, purchase price disputes, lost profits, bankruptcy, business interruption and damages assessment for mid-size to Fortune 500 companies.

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FOR MORE INFORMATION

For more information or to discuss the role of forensic accountants in detecting ponzi schemes, contact **Sareena Malik Sawhney** at **212.503.6372** or via email at **ssawhney@markspaneth.com**.