

# Always Trace the Cash

By Bert Davis Jr., CPA, CFE, CFF

I recently did the forensic analysis on a case that may have started as a legitimate business opportunity, but it quickly devolved into a combination Ponzi scheme and embezzlement. It underscored an important forensic lesson – always trace the cash.

An accountant named Sam who lived on the coast came across the opportunity to buy a set of plans for a boat that was very popular in North Carolina during Prohibition.

Sam thought it would be great to resurrect and build multiple boats for sale and discussed the opportunity with his friend Greg, who ran a boat rebuilding and repair business. Sam offered to handle the legal and financial aspects of the project if Greg would handle the manufacturing. The problem was that Sam didn't have the \$350,000 needed to buy the boat plans, so Greg put up the money. They formed an LLC to hold the plans.

## So Many LLCs

The partners estimated they needed \$2.5 million to set up a manufacturing operation. Sam proceeded to print up a prospectus and started raising money mostly from friends and family. They purchased 20 acres of land (using Greg's money) and went looking for a loan to build the plant. Sam set up one LLC to hold the land and another to borrow the money. Greg didn't understand why they needed so many LLCs, but was convinced by Sam that there were tax advantages to multiple entities.

Sam set up yet another LLC to hold funds raised from investors. Sam called them "investors" to Greg and everyone; in reality, Sam was booking the funds as loans so he and Greg wouldn't have diluted ownership. Sam also would never seem to get around to completing the paperwork needed to make the investors legitimate partners in the business. Greg was unaware of all of this because he trusted Sam.

## Investment Op Turns To Ponzi

Obviously, this was when the investment opportunity turned into a Ponzi scheme. Sam was promising the investors an immediate annual 20 percent return on their investment and was having to

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use funds from new investors to pay the returns to the first investors.

In the meantime, Sam set up yet another LLC to fund the manufacturing and Greg started building the first boat. Greg again used his own money to fund the payroll for this LLC and used employees from his other business.

Sam, while reporting that he had raised all this money from investors, never seemed to get around to providing any funds for the manufacturing operation. This effective embezzlement by Sam was a drain on Greg's other company and was keeping Greg from ever actually completing one of the new boats.

## Shady Bookkeeping

After 18 months of funding pretty much the entire operation out of his own pocket, Greg had no money from Sam and no boats built. Greg finally threw in the towel and sued Sam. Due to the complexities of the LLCs and the shady bookkeeping by Sam, the case was moved to the N.C. Business Court and I was appointed special master to figure it all out.

Frankly, it was the most factually complicated case I had worked on to that point in my career. There were effectively no financial statements or tax returns and yet Sam had managed to raise \$2.9 million, move money constantly from one LLC to another, cross collateralize assets and claimed to have nothing to show for it.

Being a CPA, I thought it necessary to try and recreate accrual-based financials. That got me nowhere and was costing the companies a lot in forensic accounting fees (well, it was costing Greg a lot because he was the only one funding the LLCs). After looking at piles of documents for a month or so, I realized that I just needed to trace the cash. Nobody



was going to court over prepaid assets or negative capital accounts or accrued expenses; they just wanted their money back.

At the end of the day, I determined that Greg was out \$1.35 million, that investors has received \$2 million of their money back and Sam had managed to pocket \$900,000. Sam's not in jail yet, but he soon will be.

And it reminded me of a great lesson – always trace the cash.

Bert Davis Jr., CPA, CFE, CFF, is the owner of Davis Forensic Group based in Greensboro, North Carolina. His firm provides financial investigation support to attorneys and their clients. Bert has conducted numerous forensic investigations, has worked as a special master in the N.C. Business Court, as an examiner in the U.S. Bankruptcy Court and has testified as an expert witness. Bert is a regular presenter for CPA and other professional groups and was recently awarded the 5.0 Speaker Award by the N.C. Association of CPAs in recognition of his receiving a perfect 5.0 rating from participant evaluations. He has a master's degree in accounting from UNC-Chapel Hill and an MBA from Wake Forest University. Contact Bert at [bdavis@davisforensic.com](mailto:bdavis@davisforensic.com) or (336) 543-3099.

