
Uncovering Landmines: Lessons Learned Conducting Forensic Accounting & Financial Due Diligence

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TABLE OF CONTENTS

Background: Profile, Clients, etc.	page 3
Forensic Accounting	
Example 1: Paper Converter and Manufacturer	page 5
Example 2: Ethnic Food Distributor	page 7
Example 3: Textile & Clothing Importer	page 11
Example 4: Electronic Components Manufacturer & Distributor	page 14
Example 5: Food Retailer / Restaurant Chain	page 17
Example 6: Food Distributor	page 20
Financial Due Diligence	
Example 1: Aircraft Parts Distributor	page 21
Example 2: Manufacturer of CDs and DVDs	page 22
Example 3: Nuclear Waste Disposal Facility	page 23
Working Capital	
Example: Operator of Retail Restaurants	page 24
Indicia of Fraud	page 25
Due Diligence Process	page 28
Sample Due Diligence Areas of Inquiry	page 29
Working Capital Approach	page 34
Who We Are And How We Are Organized	page 35
Philosophy & Attributes	page 36

- 1. Investigative accounting and consulting firm.**
- 2. 25 years of operations.**
- 3. National practice.**
- 4. Multiple industries.**
- 5. Five major service areas:**
 - a) Litigation Consulting (economic damages, accounting malpractice, etc.)**
 - b) Bankruptcy (creditor's rights, expert testimony, financial advisor, etc.)**
 - c) Due Diligence (go/no-go, pricing and structural financial determinations)**
 - d) Loan Workouts (financial triage, forensic accounting, fraud investigation, etc.)**
 - e) Portfolio Evaluations & Turnarounds.**

We serve capital sources i.e., lenders, equity groups, and their counsel

Debt & Equity Sources

Bank of American Business Capital
BNP Paribas
Caltius Capital Management
Centre Partners Management
Citibank
CIT
Comerica
Falcon Investment Advisors
Fortress Investment Group
Galena Capital
GMAC
GE Capital
Goldman Sachs Specialty Lending Group

Industrial Growth Partners
HSBC
ING Barings
Key Principal Partners
LaSalle Business Credit
Morgan Stanley
National City Business Credit
Nogales Investors Management
Praesidian Capital
Prudential Capital Group
Sage Capital Partners
Wachovia Capital Finance
Wells Fargo Bank

Law Firms

Baker, Burton & Lundy
Bodman, Longley & Dahling
Buchalter, Nemer, Fields & Younger
Cahill Gordon
Edwards & Angell
Katten Muchin Zavis & Rosenman

Latham & Watkins
Morrison & Foerster
Mullin Hoard & Brown
Otterbourg, Steindler, Houston & Rosen, P.C.
Sheppard Mullin Richter & Hampton
Winston & Strawn

FORENSIC ACCOUNTING EXAMPLE I

Background

Business Paper converter and manufacturer

Revenues \$550 million

Public / Private Public

Audited Yes - Big 4

Original Loss \$90 million among 4 lenders

Corp Structure Very complicated
2 separate loan agreements with 2 separate lenders to 2 affiliated parents and approximately 50 subsidiaries between two parents

FORENSIC ACCOUNTING EXAMPLE I

Findings

Fraud Scheme	<p>Diversion of funds of approximately \$29 million (selling borrower's collateral to affiliate, affiliate converted inventory to cash and used proceeds to pay operating expenses for borrower, instead of remitting collateral proceeds to lenders).</p> <p>Overvaluation of finished goods inventory by \$30 million</p> <p>Bill and hold invoices of \$21 million</p> <p>Unprocessed credit memos of \$8 million</p> <p>"Old school fraud"</p>
Fraud Discovery	<p>First issue identified was unprocessed credit memos of \$8 million - discovered by physical observation & inspection.</p> <p>Uncovered diversion of funds by tracing cash through affiliate - reviewed affiliate's books</p> <p>Identified bill and hold invoices by matching up invoice data with data on bills of lading</p> <p>Identified overvaluation of inventory by comparing valuations between most recent interim period and prior year end</p>
Sources of Recovery	<p>Former auditors</p> <p>Lenders decided not to fund cost and expenses associated with prosecuting claims</p>
Facilitating circumstances	<p>Audit process was flawed:</p> <ul style="list-style-type: none">Failure to perform adequate cut off proceduresFailure to perform adequate inventory proceduresFailure to perform adequate accounts receivable validity and verification procedures
Other sources of recovery	<p>None</p>
Prosecution	<p>CEO, CFO and Controller convicted - currently serving sentences</p>

FORENSIC ACCOUNTING EXAMPLE II

Background

Business	Distribution of ethnic food products, including grated parmesan cheese
Revenues	\$250 million
Public / Private	Private
Audited	Yes - Regional/Local
Original Loss	\$45 million of the \$60 million borrowed from 4 lenders
Corp Structure	Simple 2 operating entities

FORENSIC ACCOUNTING EXAMPLE II

Findings

Fraud Scheme

Created 10 intermediary companies between itself and co-conspirator

Each intermediary company was invoiced for the theoretical sale of grated parmesan cheese. Intermediary company then added 2 cents per pound and re-invoiced the co-conspirator. Co-conspirator added an additional 2 cents per pound and invoiced the affiliate. Affiliate then added 2 cents per pound and invoiced the borrower. Borrower used bogus receivables and inventories as collateral and used proceeds to pay the affiliate, who paid the co-conspirator, who then paid the intermediary companies, who then paid the borrower.

Duration - 10 years

Fraud Discovery

Happenstance

Continued questioning the owner about how he accomplished the creation of the loss

Eventual admittance of scheme by owner

Found documents to support owner's story

Used findings to obtain judgment against the borrower

Sources of Recovery

Liquidation of remaining receivables (\$15mm or \$60mm)

Liquidation of remaining inventory (\$3 of \$25mm)

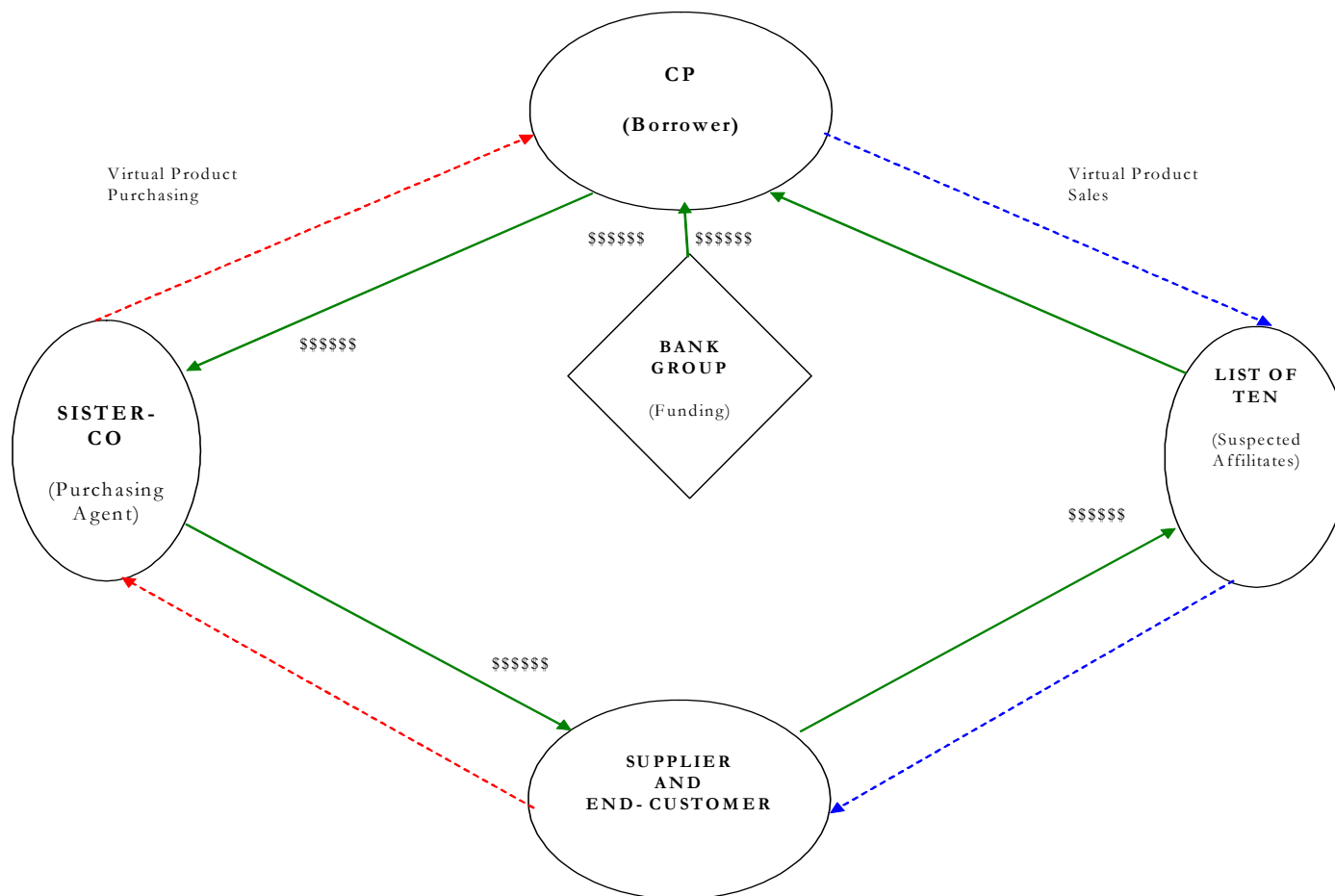
Outside auditors (largest single recovery in case)

FORENSIC ACCOUNTING EXAMPLE II

Facilitating circumstances	<p>Operational Indicators:</p> <ul style="list-style-type: none">Perish ability of inventory not questioned (i.e., cheese greater than 1 year old)Inventory activity (i.e., ins & outs at 3rd party warehouse) not reviewed.Shipping & receiving activity not questioned (to hit sales volumes, borrower would have to load-in and load-out 17 tractor trailers a day - could not do it with one loading dock during one 8-hour shift)Cheese processing facility approximately 4-5,000 square feet - incapable of producing volume of product for average daily salesUnrecognizable third party shipping companies used <p>Audit process was flawed</p> <ul style="list-style-type: none">Auditors generated 3 or 4 times the audit fees in consulting assignmentsLack of independence between audit partner and company - LA times newspaper article <p>Affiliate was not combined - would have shown potential offsets / contras and \$7 million diversion to principals</p> <ul style="list-style-type: none">9% sales growth without any new customers for a commodity product.No appreciable increase in freight expenses in last few years50% of purchases were from related parties.Payables were \$4mm and bank debt was \$60 mm - disproportionate sources of capital.Working capital deficit from operations.
Prosecution	<p>Owner signed plea agreement with SEC as co-conspirator with a publicly held company, otherwise he would have gone unpunished.</p> <p>Auditors provided the largest single recovery in the case arising from lenders reliance on their negligent misrepresentations.</p>

FORENSIC ACCOUNTING EXAMPLE II

CHEESE PRODUCER COMPANY ("CP")
CONCEPTUAL FLOW CHART OF CP'S PURCHASES AND SALES



	purchase orders
	sales invoices
	bank money

FORENSIC ACCOUNTING EXAMPLE III

Background	
Business	Textile & Clothing Importer
Revenues	\$82 million
Public / Private	Private
Audited	Yes, regional firm
Original Loss	\$25 million
Corp Structure	More complex than necessary

FORENSIC ACCOUNTING EXAMPLE III

Findings

Fraud Scheme

- Purchased inventory from related parties
- Fraudulent documents used to obtain Letters of Credit (L/C)
- L/Cs used to purchase non-existent inventory from related parties
- Inventory amounts were over-inflated to increase LC amounts
- Large amounts of in-transit inventory
- Special accounts used for sales of non-existent inventory
- Subsequent receipt of payment from special accounts were from other sources
- Export LCs used to continue cycling of cash

Fraud Discovery

- Over-advances finally stopped by Bank
- Owner confession
- Discovery of files supporting overvalued LC documents
- Documentation of related parties and transactions previously undisclosed
- Ships used in delivery of inventory were non-existent
- Notes by collusive individuals supported entries to false documents
- Receivables designated with "S" as tracking method for bogus receivables
- Customers' addresses did not exist
- Previous debt covenant explanations were not logical

FORENSIC ACCOUNTING EXAMPLE III

Sources of Recovery	Prior Lender (fraudulent concealment - jury verdict ~ \$23 million) Auditor malpractice - pending legal right of recovery
Facilitating circumstances	Audit process was flawed: Financial statements misstated (brokered sales reported gross and not net) Failure to combine financial statements of commonly controlled companies Failure to identify related parties Over-inflated inventory values not considered Sales increases not investigated: Domestic sales were to non existent companies % sales growth not explainable International sales - exponential growth in 1 year - not investigated
Other sources of recovery	Liquidation of inventory Sale of FF&E Prior lender
Prosecution	None - no interest on part of prosecutors

FORENSIC ACCOUNTING EXAMPLE IV

Background

Business	Electronic Components Manufacturer & Distributor
Revenues	\$300 million
Public / Private	Private
Audited	Yes (Big 4)
Original Loss	\$25 million
Corp Structure	Simple C Corp

FORENSIC ACCOUNTING EXAMPLE IV

Findings

Fraud Scheme

Check kiting (cashiers checks used to deposit funds in others' accts.)
Inventory and AR cycling with collusive and related parties
 Purchasing and selling of non-existent inventory (marked up \$0.25 for profit)
Borrowing against fraudulent receivables
Using money for owners' other businesses - "hopeful to repay"

Fraud Discovery

\$2 million bank overdraft
Whistle Blower
Dusty inventory and non-operative warehouse
Volume of sales not supportive of warehouse capacity
Non cooperative customers - unable to confirm receivables - claimed they did not owe
Recovery of electronic files supporting fictitious sales
Identification of documents supporting related party relationships
Most sales were made "via pickup" to other customers in business park
Sales concentration and aged receivables after line of credit was "frozen" - overdraft
Sales were to no name companies
Loans to other related parties (not permissible under debt agreement)

Sources of Recovery

Owners (\$42MM judgment - however, no assets to collect)
Auditors - malpractice claim

FORENSIC ACCOUNTING EXAMPLE IV

Facilitating circumstances	<p>Audit process was flawed:</p> <ul style="list-style-type: none">Accounts receivables were not properly evaluated (monies not traced to remitting parties)Audit - Inventory valuation (LCM) procedures were inadequate - obsolete inv.Collusive parties (related parties) not determined and investigatedOwner had other business interests requiring large sums of cashSenior in charge of audit was related to ownerFluctuations in sales variances were not substantiatedInventory system did not age inventory (data not readily available to monitor)Antiquated computer systems for financial reportingControlling owner
Other sources of recovery	<ul style="list-style-type: none">Inventory liquidation (less than \$0.10 on the dollar)Civil judgment against ownersAuditor malpractice claim
Prosecution	<ul style="list-style-type: none">Civil judgment

FORENSIC ACCOUNTING EXAMPLE V

Background	
Business	Food Retailer / Restaurant Chain
Revenues	\$100 million
Public / Private	Private
Audited	Yes (Big 4)
Original Loss	Possible purchase adjustment: \$5+ million Working capital adjustment: \$1.5 million
Corp Structure	Multiple companies

FORENSIC ACCOUNTING EXAMPLE V

Findings

Fraud Scheme

Overstatement of earnings:

Inappropriate accounting treatment (i.e., contingent gains - \$62K)

Reversal of reserves (i.e., % rent credits - \$130K)

Rebate accruals (\$5K)

Recognition of deferred gift card income (\$150K)

Understatement of expenses:

Unrecorded expenses paid in subsequent period (\$66K)

Capitalization of typical expenses (i.e., expendable equipment - \$600K)

Fraud Discovery

Liquidity issue subsequent purchase of company

Multiple expenses related to previous owners not properly accrued

Undisclosed contracts to Buyer requiring contingent liabilities to be recorded

Fluctuation of balance sheet and income statement accounts

Identification of credits to expense accounts

Journal entries lacking adequate support and calculations (explanations)

Sources of Recovery

Sellers notes and earnout provisions

FORENSIC ACCOUNTING EXAMPLE V

Facilitating circumstances	Audit process was flawed: <ul style="list-style-type: none">V.P. of Finance sole "gate keeper" of informationJournal entries lacking adequate support and calculations (explanations)Key executives' computers missing and destroyed emailsAudit procedures not comprehensive - little detailed testingExplanations provided for variances not substantiatedV.P. of Finance had equity interest in transactionFull disclosure of relevant details of ongoing contracts not disclosed even though not above scope requested by attorneys
Other sources of recovery	Possible auditor malpractice claim
Prosecution	Pending - possible civil claim(s)

FORENSIC ACCOUNTING EXAMPLE VI

Background

Business	Food distributor
Revenues	\$60 million
Public / Private	Private
Audited	Not known
Loss	Not know

Findings

Corp Structure	Simple 1 operating entity
Fraud Scheme	Fraudulently overstated collateral on borrowing base certificate to make up for working capital shortfall
Fraud Discovery	Inquiry of corporate controller Asked same question a number of different ways until the controller admitted the fraud scheme
Outcome	We were fired and were shortpaid by client
Ultimate outcome	Company ultimately filed chapter and liquidated. Don't know what % investors recovered
Facilitating circumstances	Poor oversight by stakeholders and unwillingness to make tough decisions

FINANCIAL DUE DILIGENCE EXAMPLE I

Background

Business	Distributor of new and used aircraft parts; overhauler of jet engines, landing gear, and control surfaces
Revenues	\$325 million
Public / Private	Public
Audited	Yes - Big 4
Potential Investment	\$25 million sub debt
Corp Structure	Simple 1 parent with 4 subs

Findings

Issues	Inventory grew at unusual pace
Due Diligence Findings	Poor management oversight Poor processes and controls over accounting transactions, which resulted in recordation errors at major subsidiary Inventory was not relieved in the landing gear overhaul - exchange activity, resulting in an inappropriate build up of costs. Caused ultimate demise of business due to resulting over-advance when inventory was properly adjusted
Outcome	Discovery saved our client \$25 million

FINANCIAL DUE DILIGENCE EXAMPLE II

Background

Business	Manufacturer of CDs and DVDs
Revenues	\$180 million
Public / Private	Private
Audited	Yes - regional firm
Potential Investment	\$18 million sub-debt
Corp Structure	Simple 1 operating entity

Findings

Issues	None identified prior to due diligence
Due Diligence Findings	Interim financial statements not reliable AR and Inventory reports did not reconcile to GL Inventory not properly valued Investment in bankrupt company was not written off or disclosed Material year end adjustments Laundry list of EBITDA add backs CFO had no authority - was a lapdog to the owner Owner was only signatory on bank accounts The deal that succumbed to the death of 1000 cuts

Other lessons learned Don't notify the borrower until the retainer check clears

FINANCIAL DUE DILIGENCE EXAMPLE III

Background

Business	Low-level nuclear waste disposal facility
Revenues	\$225 million
Public / Private	Public
Audited	Yes - Big 4
Potential Investment	\$15 million sub-debt

Findings

Corp Structure	Simple 1 operating entity
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Issues None noted prior to due diligence

Due Diligence Findings

Revenue recognition prior to performing services

Six months of expenses for processing, encapsulation and burial of processed waste without any associated revenues due to premature recognition

Outcome Deal turned down by sub-debt lender

WORKING CAPITAL EXAMPLE

Business	Operator of 127 retail restaurants
Revenues	\$300 million
Public / Private	Public to Private
Audited	Yes - Big 4
Original Claim	\$4.5 million from working capital adjustment related to a sale from our client to another PEG Working capital adjustment resulting in a \$4.5mm claw back claim from sellers
Adjusted Claim	\$1.8 million
Corp Structure	Simple 1 operating entity

Results

Inconsistent cut-off procedures between base period and transaction close, resulting in an adjustment to closing period's working capital of \$600k

Inclusion of inappropriate closing period's payable transactions, resulting in an adjustment of \$700k

Math error in calculating closing period's accrued payroll, resulting in adjustment of \$33K

Under-accrual of other liabilities at close, resulting in adjustment of \$250k

Duplication of accrued liabilities in base period, resulting in an adjustment of \$350k

Over-accrual of accounts payable transaction by \$1 million

- I. Bogus sales, salesmen, inventory, accounts receivable and underlying docs
 - A. Healthy skepticism
 - B. Know the salesmen and identify “House” accounts
 - C. Growth higher than historical or industry averages
 - D. Ratios substantially different than industry averages
 - AR and inventory
 - E. Ratios don’t make sense when compared to growth patterns
 - F. Too much management / central control over sales and inventory
 - G. Sales growth but loan balance does not change
 - H. Systems that are conducive to misstatement and lack of visibility

- II. Consignment sales and commission sales presented as normal sales – usually the pig in the python or it’s phony grafted on to real
 - A. Be wary of consignment sales unless historically active
 - B. Obtain copy of contract and confirm with consignee’s management and counsel
 - C. If necessary, confirm the balances quarterly

- III. Collusion among related parties in confirming AR
 - A. Know all the related parties – business purpose. Continuous search
 - B. Wives’ maiden names, children’s’ names, siblings’ names
 - C. Recognize relationships
 - D. Look for and recognize patterns out of the ordinary

- IV. Import letters of credit used to finance related party transactions
 - A. Duplicate bills of lading
 - B. Be aware of offshore related parties
 - C. Confirm ownership of offshore customers and suppliers

- V. Inflated inventory values
 - A. Fictitious product numbers
 - B. Fictitious warehouses
 - 1. Confirm all warehouse locations
 - 2. Request inventory reports by locations

- VI. Misstating COS, net income
 - A. Margins are changing
 - B. Cost components are changing (RM, DL, OH)

- VII. Check kiting among related parties to give appearance of economic activity
 - A. Request monthly lock box deposit report from bank
 - B. Understand velocity of money among related parties. High velocity should translate to high levels of suspicion

- VIII. Using inadequate software and systems to mask fraud and improper accounting
 - A. Request independent evaluation of systems
 - B. Evaluate oversight of IT department
 - C. Who has access and privileges
 - D. Demand integration

- IX. Applying received funds to ineligible AR
 - A. Checks written from one company to pay off AR of another
 - B. Agree check remittance copy to paid AR invoices

- X. Burning down warehouse to relieve inventory and collect insurance proceeds
 - Self explanatory

- XI. Continuous restatement of interim financial statements or large fluctuations between months
 - A. CFO problem
 - B. Systems problem
 - C. Periodically request computer generated financial statements to reconcile with reported numbers

Approach:

- A. Procedures developed with client and supplemented as we go
 - Tangible, Intangible, and Judgmental Areas
- B. Daily progress updates and findings
- C. Procedures typically require 5 days (10 man days) of fieldwork for a middle market company
- D. Deliverable(s) include formal or informal report
- E. Add-on acquisition assistance / diligence
- F. Tax matters are outsourced to an independent 3rd party
- G. Fees are on a time and material basis and typically range from \$40K - \$75K

SAMPLE DUE DILIGENCE AREAS OF INQUIRY

- I. 40,000 foot look

- II. How do they manage their business?
 - A. Attracting new business
 - 1. Exception reporting
 - 2. Management reports
 - B. Timing of revenue, credit memos and reserve reviews
 - C. Inventory levels, frequency of turnover review
 - 1. Overall or at the SKU level??
 - 2. Obsolescence issues
 - 3. Perpetual systems
 - a) Nature and frequency of testing
 - b) Book vs. physical adjustments
 - c) Impact on interim financials
 - D. Manufacturing costs
 - 1. Actual vs. standard
 - 2. Treatment of variances
 - 3. Adequacy of direct margins
 - E. Budgetary planning and comparisons to actual

SAMPLE DUE DILIGENCE AREAS OF INQUIRY

III. Customers and AR aging comparisons

- A. Top 10 comparisons
- B. Quarterly, semi-annual, and annual aging trends
- C. Inquire into large variations or aging of AR balances
- D. Concentration
- E. Credit limit evaluations and authorization limits
- F. Adjustments (how much and how many) to reconcile aging report to GL

IV. AR reserve calculation and basis of reserve

- A. Specific ID is not GAAP. Requires matching principle
- B. All buckets s/b effected
- C. Frequency of review
- D. Annual write-off or issue credit memos
- E. Impact on interim financials

SAMPLE DUE DILIGENCE AREAS OF INQUIRY

V. Inventory categories, values, costing methods and comparisons

- A. What's in inventory and what reports do you have to support it?
- B. Comparative categories and values of each
 - RM, WIP & FG
 - What are the larger dollar items in each category
- C. Quarterly, semi-annual, and annual balances
- D. Inquire into large variations
- E. Costing methods, full absorption?
- F. Test accuracy of labor and OH allocation
- G. Methods of capturing related expenses
 - 1. Job cost system – material, labor, and OH
 - 2. Process cost
- H. Consistency
- I. Perpetual reports reconcile to GL

SAMPLE DUE DILIGENCE AREAS OF INQUIRY

VI. Inventory reserve calculation

- A. Determined how? What is your policy?
- B. Identification of slow moving, damaged or obsolete items
- C. Turnover or aging report
- D. Frequency of review
- E. Discuss aluminum distributor
 - Big 4 audit firm
 - \$200 million sales
 - \$100 mil inventory, \$20 mil reserve
 - Reserve based on specific ID of larger items and stat sampling of other
 - B&A file dump of all inventory SKU's and related sales for last 12 months
 - 40,000 SKUs...24,000 with no turns (60%)
 - Findings: \$36 mil = no turns, \$24 mil = half turn or less, \$8 mil = half to 1 turn. Therefore, \$68 mil = less than 1 turn.

VII. Revenue recognition methods and timing

- A. Record revenue upon shipment, percentage of completion or contract benchmark
- B. Conditional / consignment / bill and hold sales??
- B. Test their methods

SAMPLE DUE DILIGENCE AREAS OF INQUIRY

VIII. Matching of expenses with revenues

- A. Retail chains take many deductions (shelf-space, advertising, etc). Record discount & allow reserve upon sale
- B. Record all applicable expenses in month relating to sale

IX. Month end closing process and interim statement generation

- A. Sit with PR, AR, AP, inventory and GL managers and discuss their month end closing procedures.
- B. Confirm management's understanding of the process or at least what they understand to the process to be
- C. Identify weaknesses in internal controls and the timing of recording revenue and expenses
- D. Is the close process controlled? Efficient? Timely?

X. EBITDA adjustments and normalization

- A. Main area of focus
- B. Effect of B&A adjustments on current year vs. prior years
- C. One-time or run rate adjustment

XI. Hardware and software systems

- Integration of systems to financial reporting package
- Existence of disaster recovery plan?

Approach:

- A. Obtain / analyze background on contractual terms and relevant purchase cutoff period
- B. Analyze pre and post monthly close procedures & policies
- C. Evaluate key indicators (i.e., GP%, DSOs, inventory turns, etc.) for deterioration
- D. Identify specific transactions to test
- E. Evaluate validity of post closing assets
- F. Test completeness of post closing liabilities
- G. Support adjustments as needed with accounting policy and procedures, ordinary course dealings, and or with GAAP
- H. Assist with arbitration, mediation or adjudication of claim

WHO WE ARE AND HOW WE ARE ORGANIZED

1. CPA's and accountants
2. Experienced auditors, financial and operational executives
3. We average in the area of 25 years experience
4. CEOs, CFOs, controllers –
 - a) Able to connect operations with financial reporting
 - b) Systems and controls
 - c) Cash flows
 - d) Historical information – both operational and financial
 - e) Forward looking
 - f) Judge the integrity and competency of management
5. Organizationally lean – 6 senior level professionals + consultants
6. Mobile – feet on the ground within 24 to 48 hours
 - a) Rapid deployment

- I. Focus on value
 - How would we do it if it was our money?
- II. Technical experts
- III. Rendering the complex understandable
 - Diagnostic and analytic excellence – critical issues determined in 1st 48 hours
 - Initial discussion with management brings issues requiring focus to the front
- IV. We build relationships for the long-term – give a good haircut, people come back...if you don't, they find a new barber. We give good haircuts every time.
- V. Senior personnel
- VI. Lean staffing – no “platooning” – no bait & switch – what you see is what you get

VII. Our mind set is solution development oriented

- Top-level smell test – does it look accurate?
- Deal impact
- Deeper investigation into the areas of concern
- Affect on EBITDA
- Long term effect

VIII. Communications & reporting

- Keep client aware of all developments good & bad – nirvana is daily
- Each report is customized and come in 3 flavors:
 - full report
 - bullet point outline
 - verbal
- No mystery in our reports
- Process and conclusions are transparent
- Nothing hidden or left to guesswork
- The issues are identified, well documented and solutions are presented

IX. Our collective audit experience results in a healthy skepticism regarding financial audits

- A. Current approach in the profession is risk-based and price-driven audits
 - Risk based – pre-audit assessment of company’s areas of operational and financial reporting risks. Audit focuses on those areas
 - Price driven – what the market will bear
 - These are not in the stakeholders’ best interest
- B. Comfort cannot be gained based on the size and reputation of the firm
- C. Requires an audit by audit evaluation



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