



Bradley S. Bell, CPA  
Jeffrey W. Birk, CPA  
Jeffrey L. Coulter, CPA

Steven A. Eichenberger, CPA  
Howard I. Gross, CPA, CFP, ABV  
Steven W. Reed, CPA, ABV

10 W. MARKET, 2300 MARKET TOWER • INDIANAPOLIS, IN 46204 • 317-633-4700  
300 S. MADISON, SUITE 410 • GREENWOOD, IN 46142 • 317-887-4072  
FAX • 317-638-5217

October 20, 2000

Mr. James A. Knauer  
Kroger Gardis & Regis  
111 Monument Circle, Suite 900  
P.O. Box 44941  
Indianapolis, Indiana 46244-0941

Re: Heartland and Related Companies

Dear Jim:

The following is a preliminary report and summary of the procedures and findings to date related to the Heartland Companies. This outline will be supplemented by more detailed attachments or exhibits as identified herein.

#### The Accounting System and Records

The construction of the accounting system and records at Heartland are consistent with most large fraud and Ponzi schemes. We found the accounting records to be incomplete, fragmented, partially missing, and deliberately altered or deleted as further described below. Our first task was to seize and control the available computer and manual accounting records at the Heartland offices, assess their condition, and proceed to recompile and pull all available accounting data into one central database of information. This is standard procedure in large fraud cases especially involving Ponzi schemes. This database will then subsequently be used to facilitate the necessary financial reporting, provide the basis for potential claims against Heartland, and potential claims of the Receiver against other parties. In addition it is critical to have all this information in one database so it can be sorted efficiently in a variety of different methods to facilitate the forensic accounting necessary to be performed.

#### Matters contributing to the complexity of the reconstruction of accounting records.

- Heartland maintained no formal financial reporting system, which would ordinarily include a conventional general ledger accounting process, trial balances, formal financial statements, and other traditional accounting and financial reporting formats.
- Heartland maintained two primary accounting information packages. One related to the investor accounting which was done in a software package called "Centerpiece" and Microsoft Access data file. Neither one of these packages were fully integrated or linked.

Mr. James A. Knauer  
October 20, 2000  
Page Two

Secondly, they maintained a "Quickbooks" check register. The Quickbooks software was never set up to produce complete financial reporting. It was used primarily to maintain current cash balances. Current cash balances were required to facilitate returns to investors and other disbursements as part of the Ponzi scheme rollover.

- Although the above mentioned software was maintained by Heartland, it was not done consistently. It was not maintained for all periods involved in our investigation, and the various databases were not integrated. An example of this is that the Heartland financial reporting system could not automatically produce tax statements, specifically 1099s, to provide investors with their gains and losses (real or artificial) or interest and dividend payments received during the year. This required a manual process that had to be performed by extracting various pieces of information from numerous databases and it took the Heartland employees approximately three months to accomplish this.
- During the period of our investigation that Heartland was being investigated by the SEC, employees of Heartland had sufficient time to "purge" the office of numerous important accounting records and documents including certain investor files and more importantly the vast majority of all original bank statements, cancelled checks and related documentation.
- Also during the end of the SEC investigation, around the period of late July to early August, employees of Heartland, under the direction of Ken Payne or a consultant hired by him, deliberately deleted numerous data files from the computer system. All employees interviewed as well as the consultant denied deleting any computer records.

The deleted computer files.

Early in our arrival at Heartland we assessed the condition of the computer files and the related databases and the integrity of the related information. As discussed above, we determined that the computer files had been tampered with and numerous databases had been deleted. However, the original software that drives those databases was still in the computer. In certain cases we were able to "crack" passwords and determine that other accounting databases containing partial information were present and had been missed in the purge process. While this was helpful, it should be pointed out that this was a very small percentage of the total information originally on the computer system. However, we were able to determine that former employees of Heartland had maintained certain backup discs containing portions of the original information that had existed prior to the data files being deleted. An assessment of the backup data indicated the following:

- While these backup files contained significant amounts of information, unfortunately they did not cover all of the time periods needed.

Mr. James A. Knauer  
October 20, 2000  
Page Three

- The integrity of some of this data was suspect due to the fact that Heartland had two server crashes prior to the data being backed up.
- None of the transactions involving the Heartland bank account had been entered into the computer or any other records except for the period May 1999 through June 2000.

#### Manual accounting records.

Immediately upon our arrival at Heartland we began a process to organize and inventory all of the manual accounting records and original source documents available at the Heartland office and to identify what was present and what was missing. During this process we were simultaneously trying to accomplish two objectives. The first objective was to identify relevant accounting information needed to rebuild the financial records of Heartland. Secondly, to identify possible missing assets and try to identify audit trails and forensic trails of accounting information that would lead to additional bank accounts and/or other assets including missing cash. This process resulted in approximately 130 boxes of information being processed. During this process we were able to find investor files containing a significant volume of original and copies of documentation related to their accounts. We were able to find other correspondence and bank accounts that will be identified below. Unfortunately, the employees of Heartland had sufficient time to remove the vast majority of original bank statements from the premises.

#### **Investor Accounting**

As discussed above, investor accounting subsequent to early 1998 was done in an accounting software package called "Centerpiece". Centerpiece is an industry specific software package designed to do investor and brokerage type accounting. It should be pointed out however that Heartland never paid for the necessary support to receive proper training or installation of the Centerpiece software. Consequently, it was not being used to its full capability or reporting potential. Significant reporting capabilities were never set up or formatted to provide for comprehensive accumulative historical activity by investor. Specifically, Centerpiece was used to generate specific transaction confirmations and summaries of investments held at any given point in time (a snap shot look), however no accumulative history was available. This is why it required Heartland employees three months to do 1099s for investors as previously discussed. Prior to 1998, investor records were kept on manual ledger sheets to the extent that they were maintained at all. In addition to Centerpiece, certain investor activity was monitored in a database package called Access. Unfortunately, Access was not integrated with Centerpiece and to produce any kind of comprehensive accounting of investor transactions required a "piece meal" approach of pulling information from several databases and required a great deal of manual effort. Specifically, this is why investors frequently were not receiving timely reports of their transactions and at the end resulted in numerous complaints. Typically what a Heartland

employee would do when an individual investor would call in with complaints or questions, was to go in by that investors name to several databases and manually pull the information together. Once this was done, fraudulent and incorrect brokerage transaction statements were generated by Heartland employees using the Centerpiece software. The following list identifies examples of some of the other issues and complexities involved in the reconstruction and rebuilding of investor accounts.

- Heartland invested very little of the total amount of investor deposits into legitimate securities transactions. Our information to date, indicates as little as \$3.5 million dollars was actually transferred for legitimate brokerage transactions. Despite this, the investor accounting and the Centerpiece software was adjusted and maintained in a manner to include, calculate and reflect the artificial and fraudulent transactions that the investor believed they were investing in. In other words, the records were maintained as if these investors had actually invested in these various stocks. Consequently, stock trades, false gains and losses on those stock trades and other related information was entered into Centerpiece. Consequently the investor account balance would roll forward with false gains and losses on securities transactions and the history of original transactions was effectively lost.
- Heartland maintained several alter-ego companies and maintained several false "internal brokerage accounts or investment accounts" within the Centerpiece system. There were approximately (10) ten control accounts and 3500 sub-accounts. The investor accounting in the Centerpiece software was substantially complicated by the fact that transfers were initiated between these various sub-accounts for false securities transactions that never actually took place.
- A major obstacle in the rebuilding of the investor files was attributable to the fact that once an investor "cashed out" or closed out their account not only was the Centerpiece account "closed" but that individuals records were physically deleted from the system. It is our speculation that this was done to minimize the incredible volume of information that was maintained in Centerpiece. This is due to the energies required to maintain open or active investor accounts, to keep track of the status of false gains and losses, to provide responses back to the investors and to calculate the perceived gains or losses from the investors point of view when those particular investors wanted to cash out. Those deleted transactions were replaced by us for the period September 1996 through August 10, 2000.
- The rebuild of the investor files has also been complicated due to the fact that from approximately late 1996 through August of 2000, approximately \$1.5 million dollars worth of investor deposits either bounced, stopped payments were issued, or the checks were otherwise returned. The accounting for these transactions by the Heartland employees was extremely poor and that has become a significant item of reconciliation.

Mr. James A. Knauer  
October 20, 2000  
Page Five

Summary of investor accounting.

We utilized the computer records that we were able to obtain from past employees, the files that we were able to obtain by "cracking" passwords and the manual original documents that we were able to locate at Heartland offices, (including the individual investor files) to reconcile and rebuild the investor accounting files to the "actual" amounts. To summarize those efforts we have the following:

- Total investors of approximately 730. Total investment transactions in excess of 12,000.
- The summary of the investor transactions is contained in attachment C. Amending this schedule for additional information obtained is an ongoing process at this time. Specifically, subpoenaed bank records are being reconciled to these files.

**Forensic Procedures and Findings**

Our forensic procedures to date can be summarized as follows:

- We searched the records of Heartland for alter-ego companies and closely related parties. These efforts have generated a current list of approximately 35 entities.
- Through the search of the records at Heartland, interviewing past employees, tracing cash transactions, and other activities, we have identified additional brokerage and bank accounts. These efforts are ongoing, however the current list of approximately 25 primary accounts and as many as 75 additional smaller bank accounts have been identified. In addition, four additional brokerage accounts that were utilized by the Heartland entities have been identified.
- Several former employees, vendors and subcontractors, and financial consultants and institutions have been contacted or interviewed by us for additional information.
- Based on the search for, and analysis of, the accounting records at Heartland (including what few original legal documents were left behind) we were able to determine that the possibility exists for significant off shore assets. See attachments A, D and E.
- Approximately \$2 million dollars was spent on the failed Belize banking project. A substantial amount of that money was paid to or controlled by an attorney in Belize named Godfrey. See attachment D.

Mr. James A. Knauer  
October 20, 2000  
Page Six

- Approximately \$1 million dollars was expended on the failed Dolphin International Project. The potential exists for a recovery of approximately \$300,000 of that money that appears to have been spent as a down payment and installment payment on a land contract to acquire land in Belize. See attachments A and E. References to Anita Alamillia.
- A significant but unknown amount of money was spent on the Twenty First Century Bank project in Grenada. The value of that bank is unknown at this time. In addition, the Treasurer of the Government of Grenada is holding a \$268,000 deposit related to the Twenty First Century Bank.
- With the analysis and identification of four additional brokerage accounts it appears that Ken Payne took delivery of actual stock certificates that were purchased on behalf of investors. The efforts to trace those transactions determine the ultimate disposition of shares is ongoing.

Cashiers checks and cash transactions.

As further detailed in the summary of expenditures from late 1996 through August 10, 2000, (see attachment A) Ken Payne, Johann Smith and Dan Danker withdrew known sums totaling approximately \$5.5 million dollars. The use of "cashiers checks", "cash withdrawals", cash withdrawals converted to cashier checks, and other combinations of cash transactions has made the audit of cash transactions difficult and time consuming to trace. Examples of the various combinations of transactions are as follows:

- Checks from Heartland payable to Ken Payne that were "cashed out" for actual cash.
- Checks to Ken Payne deposited into his personal account and then subsequently expended with "checks" but mostly with "cash withdrawals" or cash withdrawals then converted to cashier checks, mostly under \$10,000 to avoid generation of "CTR" reports.
- Investor checks made payable to Ken Payne (most checks were made payable to Ken Payne or Johann Smith) which Ken Payne deposited directly into his personal account. Some of these investor checks were then subsequently transferred to Heartland and in many cases they were not, especially towards the end of July and early August (approximately \$680,000). In many cases these investor checks were not deposited in tact into Ken Payne's account (ie he carved a "cash out" from the deposit). The possibility exists that not all deposits into Heartland's account were made in whole either. Specifically an example would be an investor writing a check to Ken Payne for \$40,000 for which Payne would do a cash withdrawal for \$9,000 and deposit \$31,000.

Mr. James A. Knauer  
October 20, 2000  
Page Seven

- In addition to the partial depositing of checks described above, there may be the possibility that Ken Payne "cashed" (cash out) investor checks written to him that were less than \$10,000.
- Ken Payne continued to use cashiers checks and cash transactions as a method to divert cash from the Heartland Companies and avoid detection to the very end prior to his flight (August 10<sup>th</sup>) despite the fact that he was advised by his attorney to cease these activities in a letter dated June 7, 1999.
- Ken Payne was assessed taxes and related penalties in excess of \$600,000 for the years 1995 through 1998 or 1999 for monies he diverted from Heartland including investor checks that he deposited directly into his account. This was a common practice for the month of July, 2000. It was also a common practice from 1993 through 1995 prior to the opening of the Lincoln Escrow Fidelity account. At this time however, it is not known how pervasive this practice was between 1993 and 1999.

#### Overall Summary

This report summarizes as briefly as possible the highlights, significant issues and status of the case to date. The process is obviously incomplete and many of the attached exhibits will change as the reconciliation and investigation continues.

The following summarizes the accompanying attachments:

Attachment A	Summary of disbursements by individual or vendor from September 1996 through August 10, 2000 for the Lincoln account. Total	\$53,744,495
Attachment B	Summary of disbursements for Heartland. Incomplete pending receipt of subpoenaed bank records. Total	\$ 2,692,115
Attachment C	Summary of investor accounts. Net investor account balance as of October 15, 1996 total \$8,927,367. Potential claims against investors receiving amounts in excess of their investment total \$5,378,450. Potential claims by investors against Heartland total \$35,315,902. Total initial investment by active investors totals \$65,661,493.	
Attachment D	Summary of expenditures for the Belize bank project.	

Mr. James A. Knauer  
October 20, 2000  
Page Eight

Attachment E            Summary of known expenditures on the Dolphin Project from the Dolphin account.

Attachment F            Schedule of additional bank accounts and brokerage accounts identified.

Birk Gross Bell & Coulter, P. C.

**DRAFT 10/20/00**