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Advocate's Edge

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The latest Association of Certified Fraud Examiners' (ACFE) *Report to the Nation on Occupational Fraud & Abuse* estimates that U.S. businesses lose 5% of their annual revenues to fraud — totaling about $652 billion in fraud losses each year. The 2006 report offers valuable lessons on how employees commit fraud, which can help facilitate its detection and protect businesses from future losses.

Asset misappropriations

Asset misappropriations represent the most common type of fraud, occurring in more than 90% of the cases in the ACFE report and producing a median loss of $150,000. Cash — including currency, checks and money orders — is the most frequently targeted asset.

Fraudsters who target incoming receipts usually steal though skimming or cash larceny. Skimming involves removing cash before it's recorded on the books. With larceny, the dishonest employee steals cash after it has been recorded.

6 common methods

The ACFE identifies six common methods for misappropriating cash via fraudulent disbursements:

1. Billing — submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases,
2. Expense reimbursements — claiming reimbursement for fictitious or inflated business expenses,
3. Check tampering — either forging or altering an employer's check, or stealing a check issued legitimately to another payee,
4. Payroll — making false claims for compensation, such as overtime for unworked hours,
5. Wire transfers — fraudulently wire transferring an employer's funds from its bank accounts, and
6. Cash register disbursements — making false register entries to conceal fraudulent removal of cash, such as voiding a sale.

Fraudsters also might misappropriate an organization's noncash assets such as inventory, equipment and supplies; information; or securities. Other valuable information subject to theft includes proprietary confidential information and trade secrets. Misappropriations of securities like stocks and bonds accounted for only 1.5% of the asset misappropriation cases in the ACFE report, but the associated median loss was dramatic — $1.85 million.

Corruption

Corruption occurs when an employee uses his or her influence in a business transaction to obtain an unauthorized benefit, contrary to the employee's duty to the employer. Corruption cases amounted to about one-third of the ACFE cases, with a median loss of $538,000.

Conflicts of interest were the most common type of corruption, constituting 62% of cases. A conflict arises when an employee has an undisclosed economic or personal interest in a transaction that adversely affects the organization.

Bribery is another form of corruption that occurs when an employee offers, gives, receives or solicits

Who commits the costliest fraud?

The Association of Certified Fraud Examiners' (ACFE's) research indicates that the level of authority a person holds in an organization has the greatest effect on the size of a fraud loss. Although most fraud perpetrators are rank and file employees or middle managers, the schemes pursued by owners and executives prove most costly — with a median loss of $1 million. A positive correlation also exists between fraud losses and annual income, since higher-salaried employees generally have the ability to misappropriate larger assets.

Similarly, the longer a perpetrator works for an organization, the higher the fraud loss. ACFE attributes this link to the trust and opportunity that go along with tenure. Employees with lengthy tenure engender more trust from their employers, which can result in more opportunity to commit fraud. Their familiarity with the organization's operations and controls (or lack thereof) better equips them to commit fraud successfully than newer employees.

something of value to influence an official act or a business decision without the knowledge or consent of the principal. A dishonest employee might process inflated invoices from a vendor who kicks back a percentage of the invoice price to the employee.

Illegal gratuities are similar to bribery, with something of value exchanged for an official act or business decision made without the knowledge or consent of the principal. In this case, an employee might receive a free vacation for awarding a contract to a particular vendor.

Extortion takes place when a fraudster coerces another to enter a transaction or deliver property based on the wrongful use of actual or threatened force, fear or economic duress. As an example, an employee might refuse to purchase materials from a vendor unless that vendor hires the employee's girlfriend.

Fraudulent financial statements

Booking fictitious sales or recording expenses in the wrong accounting period are methods used to make an organization appear more or less profitable than it really is. Even though schemes involving such falsification of financial statements were the least common type of fraud in the ACFE report, they carried the highest median loss — $2 million.

The report describes five common methods of financial statement fraud and provides some examples:

Concealed liabilities. This involves improperly recording liabilities or expenses — for example, recording revenue-based expenses as capital expenditures, thereby increasing net income and total assets for the current accounting period.

Fictitious revenues. In this case, financial statements are inflated by recording sales or services that never occurred or by inflating actual sales.

Improper asset valuations. This misstatement of the value of an organization's assets can take the form of failing to write off obsolete inventory or inflating receivables by booking fictitious sales on account.

Improper disclosures. In this case, the employee fails to disclose material information to mislead users of the statements.

Timing differences. This involves recording revenues in accounting periods different from those of their corresponding expenses.

The report also observes that, in 55% of financial statement cases, the fraudsters used more than one of these types of fraud.

Playing the odds

While many of these fraud schemes occur infrequently, it's important not to let your clients be fooled into complacency. The most infrequent schemes rate among the most costly, and a single one could prove devastating to an organization. ✧

Trade secret damages

Putting a price on proprietary information

Last year, two men attempted to sell secrets about a new Coca-Cola product for $1.5 million. While the plot was foiled, it demonstrates the enormous value trade secrets hold in many industries.

Because proprietary manufacturing, marketing and other business methods play pivotal roles in gaining and maintaining competitive advantage, businesses can't afford to take a passive approach to trade secret misappropriation.

Trade secrets 101

Understandably, many businesses fear their employees will disclose their trade secrets to new employers or rivals or use them to launch their own businesses. Corporate espionage also could lead to a trade secret misappropriation claim.

The Uniform Trade Secrets Act (UTSA) defines a trade secret broadly as:

> Information, including a formula, pattern, compilation, program, device, method, technique or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Trade secrets encompass anything held to be confidential in a business that gives the business an advantage — from customer lists and manufacturing processes to product recipes and source codes.

Unlike their intellectual property brethren — patents, trademarks and copyrights — trade secrets aren't registered with a federal organization. In fact, trade secret protection generally is asserted when other intellectual property protections don't apply. However, trade secret protection disappears when the information becomes available to the public.

Way to calculate damages

The UTSA has been enacted into law in most states, since trade secrets aren't covered by federal statute. However, damages computation varies by each. Generally, states allow trade secret owners to recover damages both for the actual loss caused by the infringement or misappropriation and any unjust enrichment to the defendant not accounted for in the actual loss.

Elements could include lost profits, the defendant's profits, the defendant's cost savings, costs related to repairing damage to the plaintiff's business, those associated with developing the trade secret, and other measures of costs saved or incurred and revenue generated or lost. In lieu of actual loss and unjust enrichment, a plaintiff might seek reasonable royalties that consider the plaintiff's loss and the infringer's benefit.

The court's take

Recently, in trade secret case *Carbo Ceramics, Inc. v. Keefe*, a federal appellate court discussed damages recovery routes. The court took issue with the plaintiff's expert's damages theory, which was based on the defendant's projected revenues. The defendant's misconduct was discovered before he had an opportunity to build a plant or manufacture products that would

compete with those of his former employer. The court thus found the projections inadmissible as speculative.

The Fifth Circuit specifically noted that the damages theory didn't fall within any of the four typical theories asserted for trade secret damages:

- ☑ The defendant's actual profits from the use of the trade secret,
- ☑ The value that a reasonably prudent investor would have paid for the trade secret,
- ☑ Costs saved by the defendant, and
- ☑ The reasonable royalty based on the amount a willing buyer and seller would agree on as the trade secret's value.

The court suggested that the reasonable royalty method was appropriate when the secret hadn't been destroyed, where the plaintiff couldn't prove specific injury and the defendant hadn't gained any actual profits that could be used to value the worth to the defendant of the misappropriated trade secret.

Build your case

In *Carbo Ceramics*, the plaintiff failed to offer any evidence pertaining to the four damages theories the court described. The court ultimately awarded summary judgment to the defendant, even though evidence supported the liability claim.

Ideally, you can present damages evidence. If not, a trade secret owner also can seek injunctive relief, and federal or state law might render the misappropriation a criminal offense, as in the Coca-Cola case. ✧

Court addresses the fair pricing of private businesses

A recent decision from the State of Delaware, *Delaware Open MRI Radiology Assocs., P.A. v. Kessler*, provides a comprehensive overview of the fair pricing of closely held businesses. While the case ostensibly involves two claims, related to the appraisal and fairness, both essentially rest on the issue of fairness.

Just the facts

The case concerned several radiologists who belonged to Fox Chase Medical Center Radiology Associates, P.C. The radiologists formed a separate company, Delaware Radiology, to run two MRI centers. Delaware Radiology subcontracted the MRI reading fees to Fox Chase.

Delaware Radiology split into two groups when three shareholders (the Kessler group) left Fox Chase and formed another practice. At that point, Delaware Radiology comprised the Broder group, which held the majority with five shareholders and 62.5% control, and the Kessler group, with three shareholders and 37.5% of the ownership. Eventually, a squeeze-out merger occurred, with the Broder group buying the Kessler group's interest in Delaware Radiology.

The Kessler group brought an equitable claim, alleging the Broder group breached fiduciary duty by effecting the merger in a procedurally and substantively unfair manner. They also brought a statutory appraisal claim. The court said it would examine the process by which the merger was accomplished and whether it was effected at a fair price, noting "that inquiry is common to both the … fairness and appraisal claims."

The valuation

To determine the fair value of Delaware Radiology's shares on the merger date, the court considered three key issues:

1. Reading fees. After the Kessler group left Fox Chase, Broder wanted Fox Chase to perform all of the reading work, charging above-market fees. The court found the Kessler group's decision to leave Fox Chase didn't give Broder the right to profit at the expense of Delaware Radiology as an entity.

2. Expansion plans. Delaware Radiology had formed plans to open at least two more MRI centers. Plans for a fifth center were inchoate, but the goal of opening it was established, according to the court. Because the expansion was part of the overall business strategy in place at the time of the merger, some value had to be attributed to all three centers.

3. Treatment as an S corporation. In reaching fair value, Broder's expert tax-affected Delaware Radiology's earnings by 40%, as if the entity were a C corporation. The court found no evidence the firm was going to convert to C status. It further held that, by virtue of the squeeze-out, the Kessler group was deprived of the benefits of membership in an S corporation, which the court discussed at length.

It concluded that "the amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company's value to the [minority] as S corporation stockholders paying individual income taxes at the highest rates — an amount that is materially more … than if Delaware Radiology were a C corporation." The court then applied an effective tax rate of 29.4% to the earnings.

By virtue of the squeeze-out, the Kessler group was deprived of the benefits of membership in an S corporation.

Hit to the pocketbook

The court held that the merger was unfair, and the Kessler group prevailed on its fiduciary duty claim. The remedy for that claim was identical to the court's appraisal award of about $5 million.

Although Delaware Radiology was obliged to pay the appraisal award, liability for the equitable award fell on the members of the Broder group, jointly and severally. An entity's failure to pay a "financially fair" amount to a minority thus directly impacted the finances of its individual members. ✧

Choosing the right guideline companies is critical

When valuing businesses, valuation experts often rely on the guideline company, or comparative company, method. With this approach, the selection of guideline companies is critical to avoiding overvaluations. Choosing adequate guideline companies also helps prevent judicial dismissal of expert valuations based on the finding that companies are insufficiently comparable.

Understanding the method

The guideline company method entails deriving market multiples from the market prices of companies that are engaged in the same or similar lines of business as the subject company and are actively traded on a free and open market. If the valuation subject is a closely held company, however, a valuator may instead look at sales transactions of comparable closely held businesses using the merger and acquisition method.

Note that it's important to use the merger and acquisition method with caution. Many of the details and terms of the sales transaction, as well as the underlying motives of the buyer and seller, may not be known. Thus, it may not be appropriate to use this method alone, but instead to use it with another appropriate method.

Both methods compare qualitative and quantitative qualities of the subject company to the guideline companies. These include, when necessary, dissimilarities related to control, marketability and liquidity.

Defining terms

The American Society of Appraisers' Business Valuation Standards define guideline companies as companies that provide a reasonable basis for comparison to the investment characteristics of the company being valued. Ideal guideline companies operate in the same industry, but if sufficient data isn't available from within the industry, a valuator could select companies in other industries. These companies should nonetheless share characteristics such as markets, products, growth and cyclical variability to the subject company.

Valuators typically use at least three guideline companies. The more similar data points that exist between the guideline and subject companies, the fewer the number of guideline companies needed.

Common factors

In assessing potential guideline companies for selection, valuators consider many of the following factors:

- ☑ Size, in terms of revenue and assets,
- ☑ Type and diversity of operations, markets, and products or services,

- ☑ Industries served and market share within them,
- ☑ Quality and depth of management,
- ☑ Capital structure,
- ☑ Off-balance sheet assets and liabilities,
- ☑ Geographic location and demographics,
- ☑ Historical and future sales and earnings growth,
- ☑ Years of operation,
- ☑ Technological development,
- ☑ Intellectual property protection such as copyrights and patents, and
- ☑ Regulatory compliance.

Valuators also analyze guideline companies' financial and operating data and adjust their financial statements appropriately so that they might adequately be compared to those of the subject company.

Make the most of the method

The guideline company method is used when it's the most appropriate based on the facts and circumstances. A valuator will provide a report that clearly indicates the search criteria used to select guideline companies. Should you wind up in court, those criteria, and those that were ignored, can prove useful when examining testifying experts. ✧