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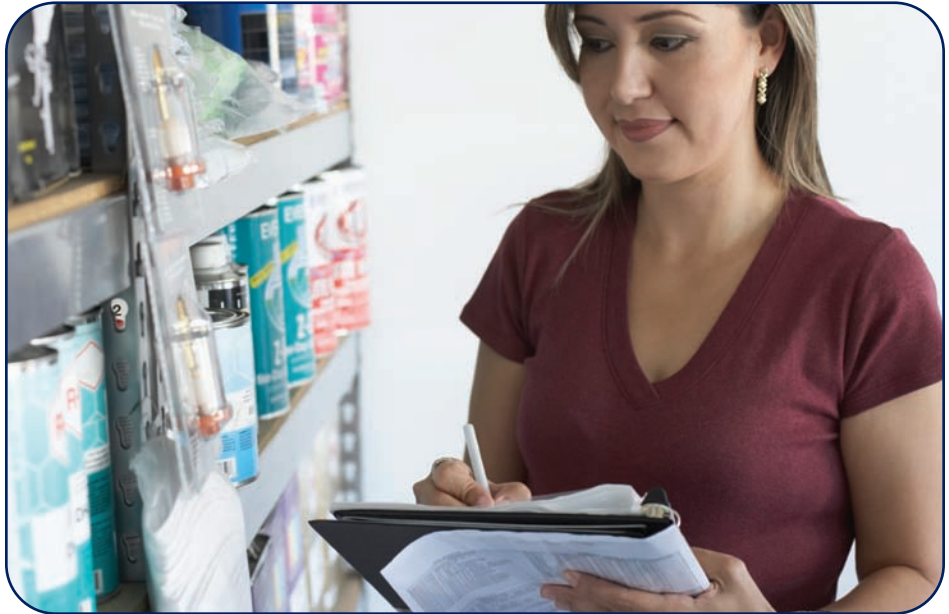
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Inventory fraud: Is that all there is?

In its latest *Report to the Nation*, the Association of Certified Fraud Examiners (ACFE) found that occupational fraud cost businesses about \$652 billion in 2006. Inventory fraud is a big contributor to these losses: According to the ACFE study, the median loss from inventory fraud schemes was \$200,000.

But inventory fraud can lead to more than just financial losses. It can also create corporate compliance issues under the Sarbanes-Oxley Act (SOX) and other laws, regulations and accounting standards.



LARCENY AND OTHER SCHEMES

The most common form of inventory fraud is theft, which fraudsters perpetrate through several methods. Primary among them is larceny, which involves the removal of inventory from the business's premises for personal use. It can be difficult to detect, because co-workers privy to another employee's pilfering often are reluctant to "tattle." They might not want to seem to side with management against "one of the gang," or they could fear management retribution for whistleblowing.

Other inventory theft schemes include:

Fake sales. In this case, an employee fails to ring up an item "purchased" by an accomplice, or the employee rings up the item at less than the actual price.

Employee discount abuse. Typically this means employees allow friends to use their employee discount when buying smaller-ticket items such as clothing. Employee discount abuse, however, can prove much costlier. Workers might sell pricey items, such as electronics, to an accomplice in bulk. And if the items subsequently are sold on the street, the business may suffer another loss — loss of customers who have found what they need at a lower price.

Returned goods. An employee might ring up an item for the accomplice at less than the ticketed price. The accomplice later returns the item for a refund without a receipt and receives a full refund for the amount shown on the ticket.

Requisition fraud. Here, employees overstate the inventory demand and then pilfer the excess items to sell or use in a side business. Employees also might help themselves to "scrap," whether in the form of excess construction materials or last year's cell phone model.

Falsifying shipments. Employees who work in a company's shipping and receiving department easily can falsify incoming shipments by underreporting the number of units received and keeping the excess. They may conceal the theft by altering the receiver's copy of shipping documents, leaving the actual number shipped on the shipper's copy. In a similar scheme, employees mark up the number on the documents associated with outgoing shipments, ship the actual number ordered and keep the extra goods.

"Temporary" fraud. This may not even appear to be fraud at first glance. Temporary fraud occurs when an employee removes or borrows inventory and uses it temporarily. For example, an employee might take a company laptop home to run his eBay store. These transgressions may not seem fraudulent, but any use of inventory diminishes the items' value.

STOP IT COLD

Businesses can take several steps to discover ongoing inventory fraud and prevent it in the future. Every company needs an express fraud policy that clearly states that pilferage is not acceptable. The policy must be broadly disseminated throughout the company and prominently displayed to encourage employees to monitor one another.

Workers often are aware of nefarious activities, so businesses should establish anonymous tip lines for employees that will also be open to third parties such as vendors and customers. In repeated studies, tip lines have been shown to cut fraud losses by as much as 50% per scheme. Businesses might also consider incentive programs, such as awarding bonuses to recognize minimal inventory shrinkage.

In addition, internal and external auditors should be employed to ensure inventory activity is all above-board. Auditors can perform statistical analyses of financial data and reconcile amounts recorded as having transferred in and out of inventory with the actual physical inventory. Companies must give auditors the authority to thoroughly investigate any discrepancies — including those involving upper executives. (See “When management is involved.”) Finally, audits should be conducted throughout the year, rather than only at the end of financial periods.

WHEN MANAGEMENT IS INVOLVED

Most inventory fraud is executed by rank-and-file employees who have access to inventory. But management-level staff may manipulate inventory on a balance sheet for far greater stakes. Managers may feel excessive pressure to satisfy financial projections or performance expectations, or to facilitate a merger or loan. The perpetrators could create records for fictitious inventory, and then support its existence with false journal entries, inventory count sheets, purchase orders, and shipping and receiving documents.

Fictitious inventory isn't the only risk. Often, inventory is purposely overstated to present a more profitable financial picture; in other cases it's understated to reduce income taxes. Management can also manipulate the company's inventory counts. A manager could, for example, include a shipment received late in the accounting period in the current inventory but record the associated liability in the next period. Further, he or she might capitalize inventory — particularly manufactured goods — improperly.

ON THE ALERT

With today's increased corporate governance responsibilities, businesses need to be on the alert, both to minimize financial losses and to avoid potential liability in shareholder suits or other types of litigation or enforcement. A forensic accounting expert can help your clients cut inventory fraud. ▀

Court rules on discoverability of draft expert reports

When experts perform valuations for litigation purposes, issues can arise over the discoverability of their draft reports and their duty to preserve them as well as correspondence related to the drafts. A recent federal district court decision, *University of Pittsburgh v. Townsend*, sheds some light on the discoverability of draft expert reports.

THE RELEVANT FACTS

The University of Pittsburgh alleged that the defendants had subverted and misappropriated its rights and interests in medical scanning technology — specifically, a combined PET/CT scanner. The university asserted that the technology had been developed collaboratively on its campus over the course of several years.

The defendants served their First Request for Production of Documents in February 2005 — more than a year before the court-established deadline for expert disclosures. In it they sought “[a]ll [d]ocuments provided to or by [y]ou, revised by, relied upon, or otherwise used in consultation with or as a basis for consultation with, any expert witness identified by [y]ou pursuant to Federal Rule of Civil Procedure 26(a)(2).”

Then, before the depositions of the plaintiff’s scientific experts in August 2006, the defendants subpoenaed “any and all” documents related to the preparation of the expert’s reports. The subpoenas encompassed all drafts and correspondence between the experts and any other individual, including the plaintiff’s counsel.



DESTRUCTION OF DRAFTS

At the depositions, each expert testified that he worked from a single working draft of his report. The experts retained neither successive drafts nor the marked-up versions they received from plaintiff’s counsel via e-mail. At counsel’s suggestion, they also did not retain those e-mails. The experts testified, however, that counsel’s comments were primarily editorial, not substantive.

The e-mails were the subject of multiple discovery requests, making it improper for plaintiff’s counsel to instruct or suggest their destruction by the experts.

The defendants moved to exclude the experts’ testimony based on spoliation and destruction of evidence. They alleged that the plaintiff’s experts and counsel had destroyed copies of e-mails between them, and that the experts had also destroyed previous drafts of their reports. The defendants further contended that, as a result of this spoliation, they were unfairly prejudiced and denied the opportunity

to cross-examine the experts about counsel’s contributions to their reports.

DUTY TO PRESERVE

The defendants argued that Federal Rule of Civil Procedure (FRCP) 26(a)(2) imposes an affirmative duty upon experts to preserve all documents, including e-mails and draft reports. The court, the defendants claimed, should sanction the plaintiff for destroying discoverable evidence by disallowing their experts’ testimony.

The federal district court declined to interpret FRCP 26(a)(2) as imposing an affirmative duty on an expert to preserve “all documents” or to require the disclosure of draft reports as part of an expert disclosure under FRCP 26(a)(2)(B). At the same time, it acknowledged that, while “not technically a required subject of disclosure ... draft reports are certainly discoverable.”

The court, however, faulted the defendants’ early discovery request for draft reports, describing it as awkwardly worded and lacking clarity. It held that the request couldn’t be construed to require production of the draft reports. And even if it could be so construed, the court found the request unreasonable based on its timing and stated that it constituted “an unreasonable request, essentially imposing a continuing obligation on a party to disclose any document from an expert ... as it is received through the consultation process.”

In the court's view, the defendant didn't make a clear request that would obligate the expert to retain and produce drafts until it subpoenaed the experts. And any drafts that previously existed had been destroyed by then. The court determined that the destruction was not done intentionally, fraudulently and to suppress the truth — therefore, it wasn't sanctionable.

DISCLOSING ATTORNEY COMMUNICATIONS

The court also confirmed that FRCP 26(a)(2) requires disclosure of correspondence from counsel if it contains “data or other information considered by the witness in forming the opinions.” The rule therefore mandates disclosure of correspondence with factual background or factual assumptions that the expert should apply when forming opinions. The court further observed that, though communications that don't include information or data for the expert to consider may not be subject to disclosure, these communications still are discoverable unless shielded by attorney-client privilege or work product protection.

The e-mails in this case were the subject of multiple discovery requests, making it improper for plaintiff's counsel to instruct or suggest their destruction by the experts. Yet counsel had admitted his error and apologized to the court and opposing counsel. In the absence of fraudulent intent on counsel's part, the court again chose not to impose any sanctions. It concluded that the defendants weren't prejudiced because they could fully cross-examine the experts on the substance of the communications and counsel's input on the reports.

HANDLE WITH CARE

The opinion in *University of Pittsburgh* imparts valuable guidance for you and your experts. At the very least, read the case as advising against encouraging your experts to destroy communications.

And if your experts can perform their duties without using draft reports, it may eliminate potential legal problems. Oral communications between your expert and you (not including discussions about the substance of expert reports or duties) also may help you avoid legal stumbling blocks. ▀

Valuing S corporations

Tax-affecting reels from another blow

The Massachusetts Supreme Judicial Court has joined the debate over an issue critical to the valuation of S corporations. In *Bernier v. Bernier*, the court considered whether tax-affecting — which reduces a business's projected future income by deducting hypothetical corporate income taxes — was inappropriate in valuing an S corporation. It described the issue as a matter that “has bedeviled the professional appraisers' community for some time, and certainly ... [was] the source of some confusion at the time of the trial.”

CLARIFICATION NEEDED

As the court noted, both case law and professional scholarship have cast serious doubt on the validity of tax-affecting. For example, in the widely cited gift tax

case *Gross v. Commissioner*, the Sixth U.S. Court of Appeals affirmed a Tax Court finding that an S corporation should not be tax-affecting to reach its value.

But in *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, a fair value appraisal case, the Delaware court took a different approach. It found that treating the business as a C corporation by a full tax-affecting would materially undervalue the business. Yet it also concluded that some degree of tax-affecting was appropriate.

DIFFERENT FMV APPROACHES

The marital estate in *Bernier* included two S corporation supermarkets, with each spouse owning half of each. Following the divorce, ownership of the stores

would transfer to the husband, and the wife would be entitled to half of their fair market value (FMV). The husband planned to continue operating the stores.

To value the supermarkets, both parties' experts applied income approaches, under which the FMV is determined by calculating the present value of the corporations' projected future income. The husband's expert reduced the future earnings by a 35% corporate tax rate — the rate that purportedly would apply to a C corporation. However, as S corporations, the stores didn't pay corporate taxes. The expert valued them at \$7.85 million.

The wife's expert declined to tax-affect the earnings and reached a value of about \$16.4 million. After reviewing both estimates, the trial court adopted the husband's expert's value.

FINDING MIDDLE GROUND

On appeal, the Supreme Judicial Court rejected the trial court's application of *Gross* to allow tax-affecting: "Careful financial analysis tells us that applying the C corporation rate of taxation to an S corporation severely undervalues the fair market value of the S corporation by ignoring the tax benefits of the S corporation structure and failing to compensate the seller for the loss of those benefits."

The court instead looked to *Kessler*, where, as here, the buyout was an "involuntary removal" — not an arm's-length purchase. The *Kessler* court rejected full tax-affecting but also held that not tax-affecting at

all was unfair. It devised an alternate approach that attempted to capture the S corporation tax benefits. It ultimately applied a "pre-dividend" corporate tax rate of 29.4%.

Both case law and professional scholarship have cast serious doubt on the validity of tax-affecting.

The *Bernier* court found that tax-affecting the supermarkets significantly understated their value and failed to adequately account for the loss of S corporation benefits to the wife. The court remanded the case with instructions for the judge to employ the tax-affecting approach adopted in *Kessler*, which it found most closely achieves the parties' intention to divide the value equally.

FUTURE OF TAX-AFFECTING

Bernier seems to make clear that the value of closely held companies with flow-through tax benefits should not be reduced by a full tax-affecting, but that adjustments for tax benefit effects (adjustments for the effect of dividend and capital tax benefits) are necessary. According to this court, the specific case facts and intentions should prevail over abstract considerations in divorce cases and, perhaps, other decisions as well. ▀

Supreme Court decision could require fresh patent valuations

A U.S. Supreme Court ruling welcomed by many in the technology arena may have made it more difficult to obtain and retain patent protection. The decision in *KSR International Co. v. Teleflex Inc.* could diminish the value of some patents and their related revenues. Because it has implications for compliance with the Sarbanes-Oxley Act (SOX) and certain accounting standards, some companies may require new patent valuations.

RULING ON THE OBVIOUS

When is an invention "obvious" and, therefore, disqualified from receiving a patent? Under Section 103 of the Patent Act, a patent won't be issued for an invention "if the differences between the [invention] and the prior art are such that the [invention] as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains."

In *KSR International*, the trial court found that every element of the defendant's invention existed in prior art, and that the state of the industry would lead inevitably to the invention. It granted summary judgment for plaintiff KSR, but the Federal Circuit reversed. The Supreme Court then criticized the Federal Circuit for addressing the obviousness question too narrowly and rigidly. Ultimately, the Supreme Court deemed the relevant patent claim obvious and not entitled to patent protection.

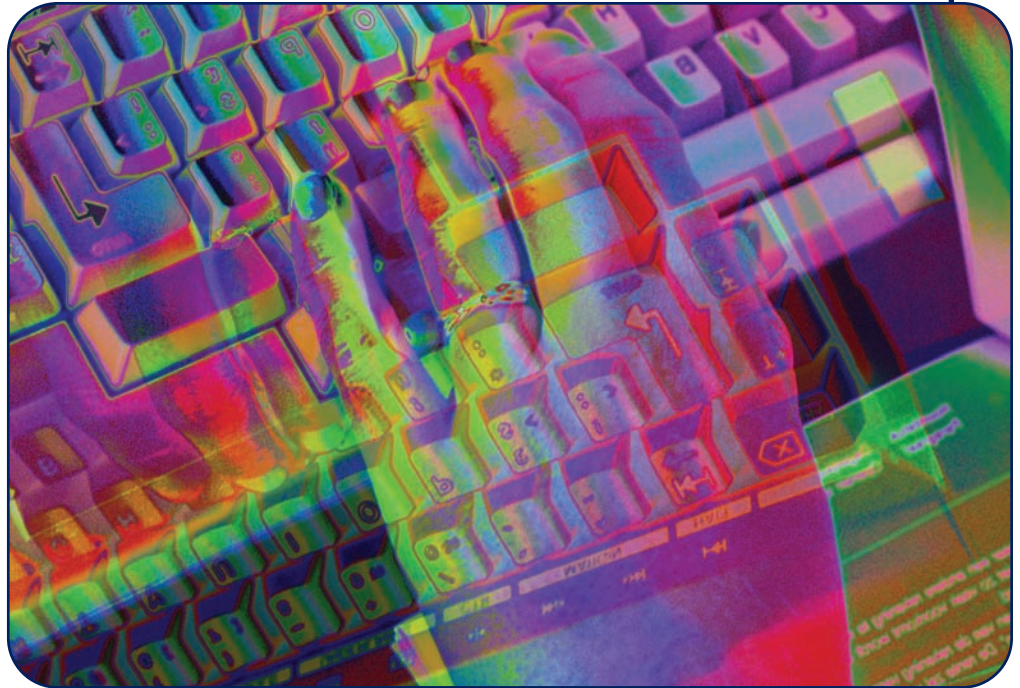
This last decision was widely considered to weaken the value of patents for their holders, and it will likely make lost profits damages harder to prove for plaintiffs. It's expected to provide alleged infringers, and would-be licensees, with a stronger defense to accusations brought by patent holders.

SOX ADHERENCE

Sections 302 and 409 of SOX require, in essence, that public companies report any substantial decline in their value. And, in light of the Supreme Court ruling, public companies may be obliged to obtain new valuations for their patents.

Sec. 302, *Corporate Responsibility for Financial Reports*, makes a company's CEO and CFO directly responsible for the accuracy of all financial reports submitted to the Securities and Exchange Commission. In particular, these executives must certify that financial statements and related information fairly present the financial condition and results in all material respects. A diminution in the value of a company's patents could render its reported financial condition inaccurate.

Under Sec. 409, *Real Time Issuer Disclosures*, public companies must disclose to the public *on a rapid and current basis* additional information concerning material changes in the financial condition or operations of the issuer. If the *KSR International* decision has materially reduced the value of a company's patent portfolio, Sec. 409 may require the company to promptly disclose that change.



THE EFFECT ON ACCOUNTING STANDARDS

Two accounting standards from the Financial Accounting Standards Board (FASB) could also call for updated patent valuations after *KSR International*. The valuation of such intangible assets plays an integral role at the time of a business combination and in mandatory annual impairment testing.

FASB 141, *Business Combinations*, requires an acquiring entity to allocate the purchase price to the fair value of assets acquired and liabilities assumed, including goodwill and intangible assets. Thus, accurate value must be assigned to any patent acquired in a business combination.

FASB 142, *Goodwill and Other Intangible Assets*, requires that goodwill and intangibles be reviewed for impairment, or overstated value, at least annually. After *KSR International*, more patents may suffer from impairment, which companies must recognize as a loss.

LONG ARM OF THE LAW

The reach of the Supreme Court's *KSR International* decision likely extends far beyond patent disputes. Your corporate clients should consider obtaining updated valuations of their patents to ensure their compliance with SOX and other regulations and standards. The potential benefits far outweigh the costs. ▀