Advocate's EDGE

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McGOVERN & GREENE LLP

CPAs & Forensic Accountants

E-mail evidence

How to build a fraud case with keyword searches

Occupational fraud continues to take a big financial bite out of U.S. businesses. But new detection techniques that apply both technological advances and well-established fraud theory can help stop employee theft before it wreaks havoc on a company's profitability.

A joint project between Ernst and Young (E&Y) and the Association of Certified Fraud Examiners (ACFE) has found that certain keywords in employee e-mail may indicate the presence of fraud. Typically, three conditions make occupational fraud possible: motivation, opportunity and rationalization (also known as the "fraud triangle"). By pinpointing the existence of such conditions, experts can better target their investigations.

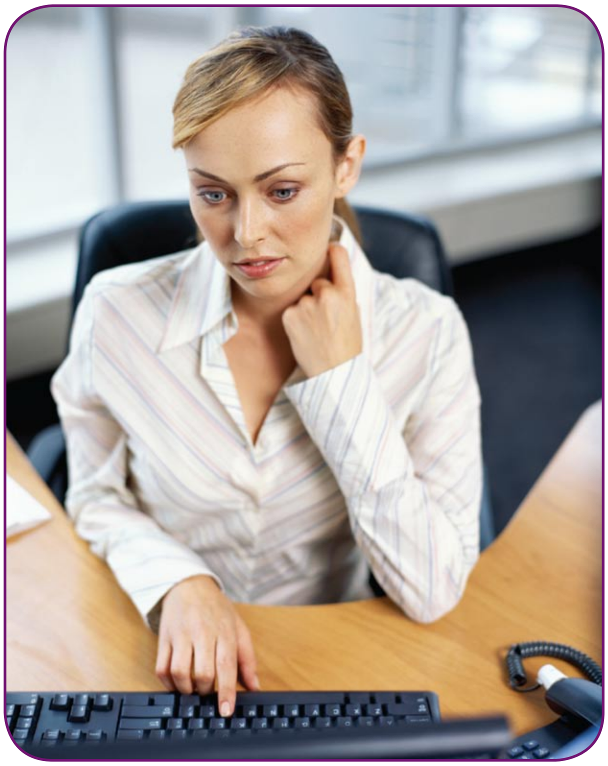
ONLY WORDS?

The E&Y and ACFE project began by questioning research that shows occupational fraud is detected largely through tips or by accident. The researchers considered it counterintuitive that, in an age of sophisticated analytical tools, most fraud is detected by decidedly low-tech means. Noting the prevalence of e-mail in today's business communications, they theorized that e-mail communication patterns could reveal a fraud perpetrator's motivation, opportunity and rationalization.

The researchers tapped extensive databases and reference materials to compile a master list of terms and phrases that appeared to be related to each component of the fraud triangle. Surprisingly, many common, seemingly innocent phrases are on the list, including:

Motivation. *Meet the deadline, make sales quota, under the gun, problem, committing, creative, concern, not sure, spread* and *revise.*

Opportunity. *Override, write-off, recognize revenue, correct, appropriate, reserve, misconduct, departing, discount, difficult, fail* and *critical.*



Rationalization. *It's OK, sounds reasonable, I deserve, therefore, find out, get back, find it, figure out, catch* and *doesn't make sense.*

Fraud investigators can use text search-and-retrieval software to search e-mail for such terms and phrases. To improve effectiveness, they customize basic keyword libraries by adding terms specific to the subject company and its previous fraud risks and experiences — for example, the names of particular accounts and other suspected employees.

CONSERVING COSTS AND RESOURCES

By performing this kind of keyword search on the e-mail of high-risk or suspicious employees, fraud experts can help the company's legal team conserve its resources and contain costs. For example, the expert can use the frequency of certain keywords to develop "fraud scores" for each employee. Employees with the highest scores may be more likely to have perpetrated fraud and, thus, warrant greater scrutiny. Or the expert can determine a particular time when fraud might have occurred by looking for periods when the frequency of all three categories of keywords increased.

Having identified the highest-risk employees and time periods, the expert can focus on journal entries and other evidence likely to corroborate suspicions. At trial, the expert links all the evidence to the fraud and the accused perpetrator in a manner that's easy for fact-finders to understand.

CASE IN POINT

The E&Y and ACFE researchers used an actual revenue recognition fraud case involving a multinational company to demonstrate the effectiveness of keyword search tools. With the aid of a library of financial statement keywords they customized for the case, the researchers found more than 1.9 million e-mails from 18 suspected executives over a three-month period.

After plotting the frequency of the keywords related to the fraud triangle over that time period, the researchers discovered a sharp increase in all three components during the period that improper revenue recognition allegedly occurred.

RETRACING THE FRAUD TRIANGLE

Even if you're familiar with the "fraud triangle" concept, you may need a quick refresher on how each condition manifests itself:

Motivation. The fraudster perceives a need that can't be satisfied in any way other than by theft. The need might stem from addiction, gambling losses, failed investments, business difficulties, divorce or simple greed. The motivation also may be work-related, such as dissatisfaction or skepticism about management's integrity.

Opportunity. This represents the only element of the fraud triangle that an organization realistically can control — but only if it eliminates opportunities. They include weak internal controls, insufficient job applicant screening, inadequate policies and procedures, poorly restricted access to information, failure to segregate financial duties and infrequent or ineffective audits.

Rationalization. The fraudster tries to justify the fraud in his or her mind. For example, perpetrators may rationalize that they're only "borrowing" the funds or that their employer deserves to be cheated.

MAKE IT EASIER

Because weak economies generally lead to a higher incidence of occupational fraud, you may be dealing with issues related to fraud evidence. Make the task easier by asking a fraud expert to apply new analytical tools such as keyword searches.

Proving lost profits

Comparable comparables are critical

Establishing lost profits, particularly for new businesses that haven't yet compiled any historical financial data, can be extremely challenging. In such cases, courts sometimes rely on data from comparable businesses. But as a recent New Jersey appellate court case, *Shalley v. Borough of Sea Bright*, illustrates, *true* comparability between the businesses is critical.

DO-IT-YOURSELF DAMAGES TESTIMONY

Garret Shalley filed an application with his local zoning board for variances that would allow him to operate a restaurant in a part of a building that had previously housed a beauty salon. After the board denied the application, Shalley sought lost profits damages from the board, among others, alleging tortious interference with contract or prospective economic relations. To avoid the expense of hiring a damages expert, Shalley chose to testify on damages himself, drawing on his prior experience in the restaurant business.

The trial court granted the defendant's summary judgment on all claims. On appeal, Shalley argued that he'd been wrongfully precluded from testifying on damages by the trial judge.

LOOKING AT RELEVANT LAW

The court of appeals explained that lost profits are recoverable only if they're capable of being established to a "reasonable degree of certainty." A plaintiff can't, therefore, recover anticipated profits that are too remote, uncertain or speculative. Lost profits need not be precisely fixed, but courts do require a "reasonably accurate and fair basis for the computation of alleged lost profits."

The trial judge pointed out that Shalley didn't know the population density of the surrounding areas for either restaurant, and provided no traffic or population density comparisons.

The court also pointed out that New Jersey is among the minority of jurisdictions that apply the New Business Rule. Under the rule, prospective profits for a new business may be deemed too remote and speculative to satisfy the standard of reasonable certainty.

PROFITS NOT PROVEN

Shalley based his testimony on lost profits on the profit margins he realized from operation of another restaurant he owned, which was located in another town. The trial judge declined to accept this information as a reasonably certain basis for the proposed eatery's projected lost profits, noting several disparities between the two locations:

- The proposed restaurant would have a different menu, supplier, name and financial scheme than the existing one,
- The oceanside location of the proposed restaurant was "uniquely different" from the first's urban location, and
- The proposed restaurant was significantly smaller.

The trial judge also pointed out that Shalley didn't know the population density of the surrounding areas for either restaurant, and provided no traffic or population density comparisons. Further, he failed to include salaries for himself and his mother in his projections or account for the necessary startup capital.

The court of appeals found that the evidence supported the trial judge's conclusion that Shalley had failed to submit an adequate factual basis "from which a jury could, other than through pure speculation, opine as to what the revenues would have been" for the proposed restaurant. Because lost profits couldn't be proven to a reasonable certainty, the appellate court also held that the question of the applicability of the New Business Rule was moot.

LESSONS LEARNED

By trying to save money on the front end, Shalley ultimately may have cost himself the case. The trial judge most likely wouldn't have barred testimony from a qualified damages expert who based lost profits projections on more appropriate — or comparable — restaurants.

Valuation reports are about more than numbers

When you receive a business valuation report it's tempting to go straight to the bottom line — your valuator's estimate of the subject business. But properly written reports contain much more information that you can use to support damages and related arguments or to attack an adversary's proposed valuation.

CRITICAL COMPONENTS

The American Society of Appraisers (ASA) has formulated a set of business valuation standards intended to maintain and enhance the quality of business valuations for the benefit of their users. According to the ASA standards, a comprehensive valuation report includes, at minimum, the following elements:

Definition of the assignment. A precise definition of the valuation assignment is vital to reaching an accurate conclusion. If the definition is inaccurate, the resulting valuation is likely to be inaccurate as well. The report, therefore, should identify the:

- Business interest being valued — for example, 100 shares of Class A stock of X Corporation,
- Purpose and use of the valuation — such as to determine fair value for dissenters' rights purposes,
- Standard of value — commonly fair market value,
- Premise or basis of value — such as going concern or liquidation basis,
- Level of value — for example, marketable minority, and
- Effective date and report date.

The definition section also may include the business's principal location, its state of incorporation, and any other assumptions and hypothetical conditions.

Assumptions and limiting conditions. The ASA mandates that appraisers state that they have no conflict that could threaten their independence or objectivity. If a conflict exists, it must be disclosed. Conflicts can be used to undermine an appraiser's credibility before a jury — even when properly disclosed in the valuation report. Attorneys who skim over a report's disclosures could put up an appraiser who's vulnerable to damaging cross-examination or miss an opportunity to poke holes in an opposing appraiser's testimony.

Where appropriate, a report must indicate that the appraiser relied on data supplied by others without independent verification, and list the sources for that data. And the report must state that the valuation is valid only for the valuation date indicated and the purpose stated.

Business description. The report must describe relevant factual matters related to the subject business, including the type of entity; history, products and services; markets and customers; major assets and liabilities; management; and past transactional evidence of value. The report also might cite outlooks for the general economy, industry and specific business, as well as discuss the business's competition and sensitivity to cyclical factors.

Appraisers need to develop an in-depth understanding of the subject business, and the business description should demonstrate this understanding. If any of the above items are missing, you need to ask why and how it could affect the valuation.

Conflicts can be used to undermine an appraiser's credibility before a jury — even when properly disclosed in the valuation report.

Financial analysis. The report should incorporate exhibits summarizing the business's balance sheets and income statements for a period of years sufficient for the valuation's purpose and nature of the business. And it must fully explain any adjustments the valuator has made to the reported financial data. If the valuator used projected balance sheets or income statements, the report must discuss the related assumptions. Every adjustment and projection warrants close scrutiny.

Valuation methodology. The valuator should disclose the methods he or she used and the reasons for their selection. The report must further document steps taken in applying such methods and explain how factors such as discount rates, capitalization rates and multiples were determined and used.

READ ALL ABOUT IT

Although the requirements above apply only to ASA members, they provide useful guidance on the baseline types of information every valuation report should include. Reports that omit such data might raise questions about the appraiser's adherence to professional standards. With the information uncovered by poring over valuation reports, savvy attorneys can develop effective approaches for supporting or tearing down valuations.

Insurance fraud: Is your client being scammed?

Insurance fraud isn't only an insurance industry problem. It's a problem for all businesses concerned about rising premium rates — not to mention out-of-pocket expenses.

Although businesses potentially can become victim to a variety of schemes intended to bilk insurance companies and workers' compensation funds, on-the-job injury and property-casualty fraud are the most common. When one of your clients suspects that an employee accident or other claim is bogus, work with a fraud investigator experienced in spotting the signs of insurance scams.

ALL IN A DAY'S WORK

Falsified injury claims, unnecessary medical services, missed work and off-hours injuries are some of the most common workers' comp scams perpetrated by employees. For example, though most accidents are legitimate, the National Floor Safety Institute claims that at least 3% of "slip-and-falls" are staged.

Experts look for several signs that such fraud is being perpetrated:

Curious timing. An employee who reports an on-the-job injury Monday morning, with no

witnesses, could be trying to pull a fast one. Workers who get hurt over the weekend pursuing leisure activities sometimes try to turn their woes into a workplace accident. Also worth investigating are employees who report an injury just before a seasonal layoff, strike or other work stoppage.

Short tenure. Workers' compensation abusers sometimes have little intention of doing any actual work, so experts look carefully at accident claims made by new employees. With a little digging, they sometimes find that an injured new employee has pulled the scam on many previous employers.

Communication issues. If, after repeated attempts, an employer can't get in touch with an employee on disability leave during the work day, it's time to investigate. The employee may be "double dipping" — working another job while collecting benefits for an injury that supposedly makes work impossible.

Medical irregularities. Scam artists may describe their accident differently to their employers than they do to their doctors. "Injured" employees also change medical providers frequently and may refuse diagnostic procedures.

SUSPICIOUS CHARACTERS

Like fake workers' comp claims, property-casualty fraud can be detected if you know the signs. An auto accident claim could be false, for example, if witnesses aren't available to support the claimant's story, or if an overly enthusiastic witness or one related to the claimant comes forward at the 11th hour. Fraudulent claimants also frequently push for an immediate cash settlement and may threaten the insured with adverse publicity if the claim isn't settled quickly.

Such perpetrators may be unwilling to provide identification or a verifiable address. Related behavior includes frequent changes in home address and telephone number, a preference for handling business in person, or reluctance to use the U.S. mail service. In these cases, further investigation often reveals that the claimant has an active claims history under various aliases.

Restaurants and retailers frequently are victims of food poisoning scams. In the case of fraud, the claimant usually is the only person to get sick, and he or she may be unable to produce a foreign or contaminated substance to support a claim. Similarly, manufacturers could be fraud targets if a product liability claimant produces only a package wrapper or box — not the allegedly dangerous product.

An employee who reports an on-the-job injury Monday morning, with no witnesses, could be trying to pull a fast one.

PREVENTION IS THE CURE

In addition to investigating workers' comp or property-casualty claims, a fraud expert can help your clients prevent such fraud from occurring in the first place. Businesses need to establish and clearly communicate procedures for filing claims, and reporting and investigating incidents, and managers should be taught to spot the signs of insurance fraud.