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Occupational fraud report: The usual suspects?

In rough economic times, every dollar counts and the cost of employee fraud can hit a business especially hard. Identifying fraud perpetrators as early as possible is critical to containing losses.

The Association of Certified Fraud Examiners' (ACFE's) latest *Report to the Nation on Occupational Fraud and Abuse* collected and summarized information on almost 1,000 cases of employee fraud. The report's results can help businesses and their legal counsel spot the signs of occupational theft and understand how demographics, job responsibilities and level of authority are connected to certain types of fraud.

DIVING INTO DEMOGRAPHICS

Of the report's fraud cases (which were investigated between January 2006 and February 2008), more than half involved a perpetrator over the age of 40, with more than one-third of the schemes committed by employees between the ages of 41 and 50. The median loss for businesses rose as the age of the perpetrator increased — a fact likely explained by the fact that higher-level positions are occupied by more experienced and older individuals with greater authority over, and access to, company resources.

As they did in past ACFE reports, results indicated that most frauds were committed by men, who were also associated with a median loss more than twice as great as that caused by women. The ACFE hypothesizes that the disparities reflect the remaining "glass ceiling" phenomenon — men hold more management and executive positions and, thus, have more opportunity to perpetrate large-dollar frauds.

The highest percentage of schemes were committed by employees in the accounting department, with more than one-third of those cases related to check tampering.

Thirty-four percent of the perpetrators had only a high school education, but more than half had attended or graduated from college. As education level rose, though, so did the median fraud loss. Those with graduate-level education (11% of the total) caused a median loss of $550,000 compared with $210,000 for those college educated and $100,000 for high school–educated perpetrators.

POSITION = OPPORTUNITY

The ACFE reported that employees and managers committed most occupational frauds. Although owners and executives were involved in just under 25% of the cases, the median loss for these frauds was $834,000 — more than five times greater than those caused by managers, and more than 11 times greater than those by rank-and-file employees.

Despite the fact that they were less represented among perpetrators, owners and executives were responsible for more than half of all financial statement frauds and almost 40% of the corruption cases. Managerial fraud split almost evenly among financial statement fraud, corruption and asset misappropriation.

Not surprisingly, the highest percentage of fraud schemes were committed by employees who worked in the accounting department, with more than one-third of those cases related to check tampering. These employees typically have the best access to their companies' fiscal assets and the best opportunity to conceal a scheme. Executive and upper management (considered as a department) was the second most common category of perpetrators.

It's interesting to note, however, that the ACFE report found no correlation between an employee's tenure with the company and when he or she was likely to begin committing fraud. About half of the perpetrators had been with their companies for five or fewer years. But longer-term employees tend to commit much costlier frauds.

INCOME PLAYS A ROLE

The role income plays in occupational fraud is consistent with many of the report's other findings. Employees earning less than $50,000 per year perpetrated more than 40% of the ACFE frauds. This makes sense considering most organizations have more employees in this income bracket than in higher brackets. Further, lower paid employees may have greater motivation to commit fraud because they're more vulnerable to financial pressures.

Those with higher incomes were responsible for fewer, but more costly, frauds. The median loss for schemes by employees making less than $50,000 was $75,000, but the median loss for those by employees making more than $500,000 came in at a whopping $50 million.

BAD BEHAVIOR

These results may seem discouraging, but businesses can spot red-flag behavior if they're looking for it. According to the ACFE, the most common warning sign of occupational theft is an employee living beyond his or her financial means. If, for example, a junior accounting staffer buys a new luxury car, the situation may merit scrutiny. It could turn out that the employee has other, reasonable sources of income, but an investigation might also reveal a billing scam.

Other warning signs include:

- Control issues and an unwillingness to share duties,
- Unusually close relationships with a vendor or customer, and
- Financial difficulties.

LESSONS FROM THE MADOFF CASE

Last year's revelation about financier Bernie Madoff's unprecedented Ponzi scheme — which victimized sophisticated and novice investors alike — sent waves of alarm through the investment community. Madoff's scam only highlights the value of forensic accountants.

The head of the nonprofit group Securities Investor Protection Corporation revealed in December 2008 that Madoff maintained different sets of books. One set tracked the actual losses at Madoff's firm, while the other, false set was shown to investors. The FBI and many of the scam's victims have brought in forensic accountants to track the lost money. These experts will comb over financial records and invoices to find misstatements and other incongruities.

The Madoff case also illustrates the distinction between the services of auditors and forensic accountants. Madoff's firm passed muster in repeated financial statement audits performed by major auditing firms, but a successful audit is no guarantee everything is above-board.

Because one of the key motivating factors behind fraud is financial difficulties, the ACFE suggests organizations devote more effort to conducting credit background checks on job applicants.

It's worth noting, however, that the vast majority of occupational fraud is committed by first-time offenders. In 87% of the report's cases, the perpetrator had never been charged with or convicted of a fraud-related offense before discovery of the immediate scheme. Even where the employee had been punished or terminated for fraud by a previous employer, that company may have been unwilling to press criminal charges or take other public actions. Nevertheless, businesses should always verify resumé items, including previous employment.

DAMAGE CONTROL

None of the characteristics or behaviors documented in the ACFE report are conclusive, and their existence alone doesn't confirm that fraud is occurring or will occur. But knowing about these relationships between fraud and the kinds of employees more likely to perpetrate it may help businesses recognize it sooner and limit its damage. ◗

Rocky economy alters the valuation landscape

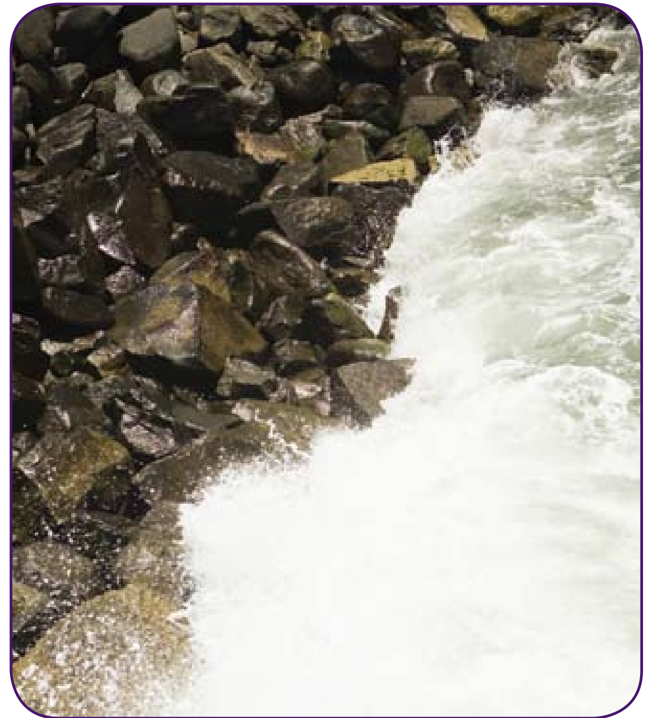
The ripple effect of the global economic downturn has reached the realm of business valuation. As the value of real estate and businesses in many industries has dropped dramatically, valuators have been forced to change some of their methods. Attorneys, in turn, may need to adjust their expectations in several areas of practice.

THE EFFECT ON ESTATE AND GIFT PLANNING

Declining business values are creating both opportunities and obstacles in different legal areas. In estate and gift planning, the assets in an estate typically are valued as of the date of death. However, federal tax law allows an alternative valuation date of six months after death. If values continue to drop, using this alternative date may lead to reduced tax liability.

Similarly, a taxpayer planning to make a gift of real estate or an interest in a business might want to delay the transfer if he or she believes the value of the underlying asset will continue to decline. When values are low, a taxpayer can move more assets for the dollar out of his or her taxable estate. When an asset begins to appreciate again, it will no longer be part of the estate.

Projections generally will require more research, because valuators must compile more material to support their valuations.



SHIFTING DIVORCE STRATEGIES

Attorneys may also need to rethink some of their practices in divorce cases. If one spouse has an interest in real estate or a business that has lost value, the nonowner spouse will receive less when splitting the interest's value. These decreasing values are, in some cases, moving up divorce dates. The owner spouse wants to act while assets have low values while the nonowner spouse worries that values will drop even more.

Because values are changing so quickly and significantly, some courts are actually reconsidering divorce settlements. In today's economic conditions, a settlement can't be assumed until the final decree is signed and filed.

OTHER LEGAL CONSIDERATIONS

Shareholder disputes may also be affected by declining values. For example, in cases where the wrongdoer's payout will turn on the value of a business, the impact may be strongly felt.

Depending on the industry, merger and acquisition transactions may also need to adjust to the changing economic landscape. Buyers and sellers might rethink their business combination plans, or at least take into account various timing issues. For example, previously comparable sales may no longer provide a reliable, apples-to-apples basis for setting a purchase price.

CHANGING VALUATION METHODS

In an economic arena that's radically different from those of previous historical periods, valuators can't necessarily rely on historic data and multipliers. They need to incorporate more up-to-date figures using, for example, monthly data where they formerly might have used year end data. Similarly, when considering a business's cash flows, a valuator must look at current sustainable cash flows instead of historic ones. Projections generally will require more research, because valuators must compile more material to support their valuations.

Attorneys can make valuing businesses easier by taking a more proactive approach. You should, for example, bring in a valuator early so the expert can track the subject company's changing fortunes and help you better time your actions. Also be prepared to provide more information than you previously did.

PROCEED WITH CAUTION

Until stability returns to the U.S. economy, attorneys must exercise extreme caution when it comes to value. Don't just accept a valuation on its face.

FLP update

Surviving the latest IRS challenge

For years, the IRS has used a variety of tactics to challenge family limited partnerships (FLPs). In 2008, it took a relatively new approach — arguing that transfers of partnership interests in an FLP were actually taxable indirect gifts of the assets held by the FLP. But the U.S. Tax Court rejected the IRS's argument, as well as its claim that the "step transaction" doctrine applied, in the latest case to consider this argument, *Gross v. Commissioner*.

GROSS ANATOMY

Bianca Gross was a widow in New York with two adult daughters and more than $2 million in publicly traded securities. To involve her daughters in the management of the portfolio, she decided to form an FLP. Gross and her daughters agreed to the essential terms and conditions of the FLP and filed a certificate of limited partnership with the New York Department of State on July 15, 1998.

Between Oct. 15, 1998, and Dec. 4, 1998, Gross transferred securities to the FLP. On Dec. 15, 1998, she transferred a 22.25% limited partnership interest to each daughter and also executed a document titled "Limited Partnership Agreement."

Gross filed a gift tax return that reported the gifts at a net value of $312,500 after a 35% discount. The IRS assessed a deficiency of approximately $121,000, claiming Gross had made an indirect gift of $480,299. In its notice of deficiency, the IRS claimed that Gross' transfers were not direct gifts of FLP interests but rather indirect gifts of the securities she'd contributed to the FLP.

CRITICAL DATES

At trial, the IRS argued that formation of the FLP, the daughters' acquisition of limited partnership interests and Gross' contributions of securities all occurred on Dec. 15. Gross countered that the FLP was formed on July 15, the securities were contributed by Dec. 4 and the gifts occurred long enough after Dec. 4 that no indirect gift occurred.

The IRS contended that the FLP wasn't created until Dec. 15 because New York law requires that a partnership agreement be executed before a limited partnership can be formed. But, as the court noted, New York law provides that, when parties seeking to

form a limited partnership don't satisfy the requirements, they may be deemed to have formed a general partnership "if their conduct indicates that they have agreed, whether orally and whether expressly or impliedly, on all the essential terms and conditions of their partnership arrangement."

Make any initial contributions described in the agreement as soon as possible and reflect the contributions in the partners' capital accounts.

The court found that Gross and her daughters had agreed to form a partnership on the terms dictated in the eventual partnership agreement by the time the certificate was filed on July 15. The FLP, therefore, was formed on that date.

INDIRECT GIFTS

The IRS claimed that, regardless of the date the FLP was formed, Gross had made indirect gifts to her daughters because she'd contributed her securities to the FLP for inadequate consideration.

It also argued that she'd received inadequate consideration because, proportionate to her interest in the FLP, only 55.5% of the value of the securities was credited to her capital account in the FLP. She'd made indirect gifts, the IRS continued, because the securities' remaining value was credited to the daughter's capital accounts, proportionate to their FLP interests. In response, Gross argued that 100% of the value of the securities was credited to her account well in advance of her gifts of the FLP interests.

The court found that Gross had made a series of contributions and received increasing partnership interests in return. All of the contributions were reflected in her capital account, and the value of the daughters' capital accounts wasn't enhanced as a result of the contributions. After completing her contributions, Gross made gifts of partnership interests. Therefore, the form of the transactions accorded with their substance: The transfers were direct gifts of FLP interests, not indirect gifts of securities.

STEP TRANSACTION DOCTRINE

The IRS also asserted that the transfers were indirect gifts under the step transaction doctrine, which embodies substance over form principles. It "treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent and focused toward a particular result." In such cases, the tax consequences are determined by considering all of the steps as an integrated whole.

The Tax Court had considered a similar IRS argument three months earlier in *Holman v. Commissioner*. In that case, it ruled against the IRS, concluding that the taxpayers bore a "real economic risk of a change in the value of the partnership for the six days that separated their transfer of the shares to the partnership and the gift."

The court reached the same conclusion in *Gross*. It declined to apply the doctrine because 11 days had passed between the conclusion of Gross' transfer of securities to the FLP and her gifts to the daughters, and the securities were mostly heavily traded, relatively volatile common stocks subject to changes in value.

TIPS FOR PRACTITIONERS

Both *Gross* and *Holman* offer some insights into how an FLP can survive this type of IRS challenge. Among them:

- Don't delay execution of the partnership agreement or other formalities.
- Make any initial contributions described in the agreement as soon as possible and reflect the contributions in the partners' capital accounts.
- As additional contributions are made, increase the ownership percentage of the contributing partner and credit his or her capital account.

Also, the appropriate delay between the contribution of assets to an FLP and the transfer of interests in an FLP should depend on the nature of the assets. The delay needs to create a real economic risk of a change in value.

ANTICIPATE ATTACKS

Although the IRS has now suffered defeat twice on the indirect gift argument, it may continue to pursue this route. Attorneys need to anticipate all such attacks when forming and administering an FLP to help ensure their clients obtain the expected tax benefits. ◗

What to expect from your financial expert

While working in the areas of dispute resolution, litigation and potential litigation, financial experts wear many hats. To ensure the quality of these experts' litigation support services, one of the foremost professional groups of appraisers has issued guidelines on the proper role of the independent financial expert. Although the American Society of Appraisers' (ASA's) guidelines aren't binding, they suggest specific procedures that attorneys can expect from the financial experts they engage.

RANGE OF REASONS

The guidelines recognize many of the reasons financial experts may be retained, including to:

- Provide an expert opinion on the financial effects of facts and assumptions,
- Value a business,
- Project future financial results,
- Analyze the performance of a business operation,
- Interpret financial data, and
- Opine on an impaired stream of earnings.

In performing these services, they may act as an expert, expert witness, arbitrator, court-appointed expert, or consulting or advisory expert.

CONDUCTING THE ASSIGNMENT

The ASA guidelines outline the general process an independent financial expert should follow in performing a litigation support engagement. Initially, for example, the expert should determine the reasonableness and appropriateness of key assumptions and hypothetical conditions. The use of unwarranted assumptions may impair an expert's objectivity.

The expert also should consider whether it's necessary to rely on the work of a specialist, such as a valuator with intellectual property expertise. Where such reliance exists, the expert may wish to consider the specialist's independence and competence. What's more, the specialist's conclusions should be documented, and any written opinion or report retained.

The expert should document all work performed in an engagement, allowing the circumstances and needs of the engagement to determine the form and extent of work papers. He or she also should retain on file — or have access to — all information relied on in the engagement. The expert further needs to determine whether a client representation letter is necessary and, if possible and applicable, attach a representation letter from management or other representatives of the underlying business to the engagement documentation.

In addition, the expert should document the work methods selected, along with the reasons for selection. He or she also needs to document specific procedures and reasons for selection, key areas considered and significant assumptions. Finally, the expert should retain a copy of all calculations, explanations and documentation supporting his or her final conclusion.

NOT A STANDARD OF CARE

Note that the ASA guidelines aren't intended to provide the basis of any civil liability and shouldn't create any presumption or evidence that a legal duty has been breached. Rather, they can help you develop reasonable expectations of your financial experts and understand your own role in assisting them. ◗

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