

— Advocate's EDGE —



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Stop purchasing fraud in its tracks

In tough economic environments, it's especially important to guard against one of the most prevalent forms of occupational theft: purchasing fraud. Participants in the Association of Certified Fraud Examiners' 2010 study of worldwide fraud — *Report to the Nations on Occupational Fraud and Abuse* — reported a median loss of \$500,000 due to purchasing department fraud, as opposed to \$160,000 for all types of fraud.

The temptation to steal can be strong for employees with financial troubles and access to their company's accounts. Strong internal controls, therefore, are critical. And if you suspect purchasing fraud is afoot, enlist the help of a forensic accountant right away.

WHO COMMITS FRAUD?



The Association of Certified Fraud Examiners' most recent *Report to the Nations* studied not only the types of occupational fraud committed, but their perpetrators.

The study found that, in 58% of cases, managers, owners and executives, who generally have greater access to company funds, were responsible. About 67% of frauds were perpetrated by men — higher than in the 2008 study, but consistent with historical trends — and more than half were committed by individuals between ages 31 and 45.

More than 40% of the perpetrators had been with their organization between one and five years, and about half had been employed for more than five years. And 86% had never been charged with or convicted of a prior offense. Although this last finding is in line with previous ACFE reports, it's always a sobering statistic for owners to consider when they hope to spot potential thieves.

TRICKS OF THE TRADE

What makes the purchasing function so vulnerable to costly fraud schemes? Employees responsible for purchasing have access to accounts payable, purchase orders and vendor files. They're also likely involved in choosing vendors and approving invoices. This kind of access creates the opportunity for several types of fraud, including:

Kickbacks. Here, a vendor pays an employee to provide inside bidding information or facilitate payment of a fraudulent invoice. The vendor also may incorporate the kickback amount in the price it charges the company, thereby compounding the amount the company is overbilled.

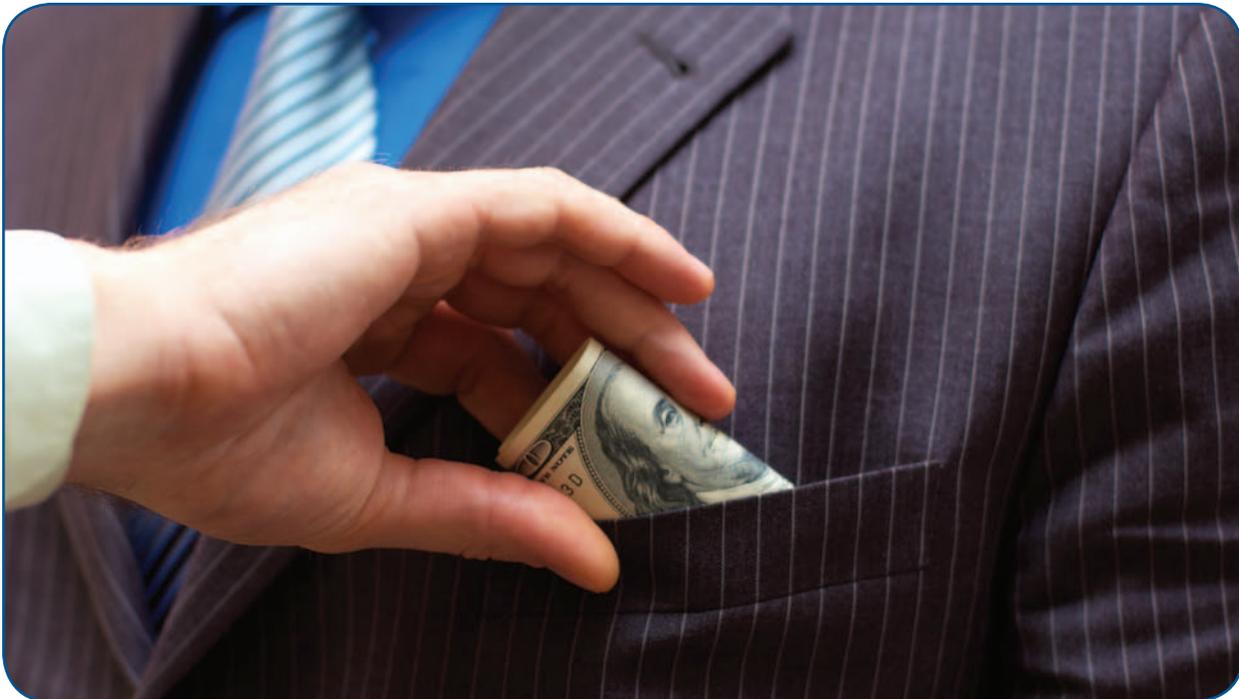
Fictitious vendors. Working alone or with an accomplice, an employee sets up a fake company and enters that company into the employer's accounting system as a vendor. The employee then creates fake invoices for the "invented" company and ensures that they're processed and paid.

Overbilling. An employee submits or approves altered or inflated invoices for goods and services, and the overpayment is diverted to the employee's personal account or to an accomplice.

Conflicts of interest. An employee with an interest in a vendor's financial well-being, such as an ownership stake or family connections, sends business its way. Conflicts of interest may not seem like grievous offenses, but they often lead to other purchasing fraud schemes.

SOMETHING ISN'T RIGHT

Your clients can help uncover such fraud schemes by keeping an eye out for purchasing anomalies. For example, does one vendor receive most or all of the company's orders, to the exclusion of other vendors that offer comparable or better pricing?



Conversely, has the company made a one-time, significant purchase from a vendor that hasn't been properly set up and cleared by accounts payable? Is accounts payable processing payments for photocopied invoices, invoices from companies with a post office box only or invoices in amounts that fall just under the amount that would require a manager's review? Although most of these incidents will likely turn out to be innocent, it's important to investigate anomalies for the one that isn't.

RUNNING THE NUMBERS

When a company suspects purchasing fraud is taking place, a forensic accountant will investigate by reviewing documents and interviewing employees. To speed the process, experts also use data analysis to search for signs of fraud, including:

- ▶ Shared addresses, phone numbers, or bank accounts between employees and vendors,
- ▶ Duplicate invoices from a single vendor,
- ▶ Missing or inconsistent data,
- ▶ Successively numbered invoices from a vendor suggesting that the vendor isn't billing any other customers, and
- ▶ Invoice amounts in large, round numbers.

Data analysis also can discern incriminating trends by examining the historical number of invoices submitted and the amount of payments to specific vendors. For example, if the amount of a vendor's invoice increases in increments of \$100 month after month, it may be a fictitious vendor.

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GET WHAT YOU PAY FOR

Few companies can afford to fall victim to a costly purchasing fraud scheme — especially in a recovering economy where every dollar counts. A qualified financial expert can work with your clients to detect and eliminate purchasing fraud and put protections in place so that employees are less likely to try such schemes in the future. ▶

Expert's lost-profits opinion hits the nail on the head

Establishing lost-profits damages can prove difficult — especially when a case involves a new business in a volatile industry. But a recent breach of contract and fraud case, *LB 4 Fish, LLC v. Developers Diversified Realty*, showed that solid testimony from a qualified financial expert can help attorneys make their case.

LEASE DISPUTE LEADS TO LITIGATION

In this California circuit court case, Developers Diversified Realty (DDR) obtained the right to develop and operate a retail, entertainment and dining hub on the waterfront in Long Beach, Calif. The development would have a number of restaurants but only limited nearby self-parking available. Thus, the patrons of some of the businesses would have to rely on valet parking.

LB 4 Fish signed a 20-year lease with DDR in November 2001 to operate a Gladstone's restaurant in DDR's development, and parking was a critical issue in the negotiations. The number and location of valet stations, hours of valet operation, and quality of the parking services were significant considerations for the restaurant.

But valet parking wasn't always available during Gladstone's operating hours for more than a year after it opened in November 2004. The promised number of valet stations never materialized, and valet services that were provided were, according to Gladstone's, "insufficient, understaffed, unorganized, and inadequate for Gladstone's patrons." Cars stacked up, causing gridlock and preventing customers from reaching the restaurant so they could drop off their cars. In addition, valets left cars illegally parked.

LB 4 sued DDR for fraud and breach of contract, seeking damages for lost profits. The jury found in favor of Gladstone's, and DDR appealed.



EXPERT DOES THE MATH

Gladstone's supported its lost-profits claim primarily with testimony from an expert witness who was an accountant and lawyer. DDR argued that his lost-profits calculation wasn't established with reasonable certainty, as required, because it was based on restaurants that weren't comparable.

To reach his lost-profits calculation, the Gladstone's expert examined many data sources, including:

- ▶ The lease between Gladstone's and DDR,
- ▶ Gladstone's monthly financial reports and daily sales reports,
- ▶ Several comprehensive commercial databases with restaurant statistics,
- ▶ Gladstone's forecasts, and
- ▶ The National Restaurant Association's industry forecast.

From these sources, he gleaned information about restaurants' working capital, returns on investment, assets as a percentage of sales and other financial metrics.

The expert looked at more than 1,000 restaurants and narrowed his list to about a dozen that were independent, waterfront restaurants with a seafood format, but which weren't considered gourmet or fast food. He examined the average seat comparison (the amount earned per seat) for these restaurants and determined that Gladstone's ranked in the 25th percentile for California restaurants, at about \$24,000 per seat per year.

From this figure the expert projected annual revenues of about \$10 million, which he reduced according to the industry forecast. He also lowered the 2005 revenue projection to account for a ramp-up period.

Finally, he arrived at approximately \$4.7 million in lost profits for the period of January 2006 through May 2008.

The court found that the restaurants the expert considered were indeed comparable to Gladstone's. It also noted that the expert relied on a number of sources, which contributed to the certainty of the damages.

BUILDING A SOLID FOUNDATION

The court in this case concluded that the evidence was sufficient to provide a foundation for the expert's lost-profits opinion and, in turn, the jury's award. It illustrates the importance of hiring an expert who can conduct thorough research and analysis and apply appropriate comparables when building a damages claim. ▶

Valuation relief for IP headaches

Intellectual property (IP) is a significant source of value for many companies these days, but it can be a pain to appraise. In fact, the three most commonly applied valuation methods — market, income and cost — aren't always effective when valuing IP. In many cases, professional valuers turn to the relief from royalty (RFR) method for these tricky assets.

GRIPPING A SLIPPERY SUBJECT

Most IP generally falls into one of four broad categories: patents, copyrights, trademarks and trade secrets. But IP also may refer to unpatented proprietary technology, trade names, trade dress, brands, computer software, customer lists and other assets that fall within, or are closely related to, the four categories listed above.

Almost as numerous as the types of IP are the reasons for valuing it. They include: financial reporting (fair value measurements, annual

impairment tests); tax compliance (gift and estate taxes, charitable contributions); litigation (damages calculations, shareholder disputes, divorce, bankruptcy); and sale or licensing transactions (mergers and acquisitions, IP sales/licenses).

STANDARD CHALLENGES

Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*, contain information critical to valuing IP. Companies are required to:

1. Allocate the purchase price of an acquired company among the tangible and intangible assets being acquired (SFAS 141), and
2. Test acquired goodwill and other intangibles annually for impairment and write them down if their fair values drop below their carrying amounts (SFAS 142).

Testing goodwill for impairment is a particularly complex process. But, in general, the value of goodwill depends on the value of a company's tangible and *identifiable* intangible assets, including IP.

SUITABLE ALTERNATIVE

IP assets can be valued using one or more methods within the three basic valuation approaches: market, income and cost. When applied to IP assets, however, the cost approach may not be effective because valuers can't identify and quantify all of the costs involved in creating an IP asset. Moreover, the cost of creation may have nothing to do with the IP's value.

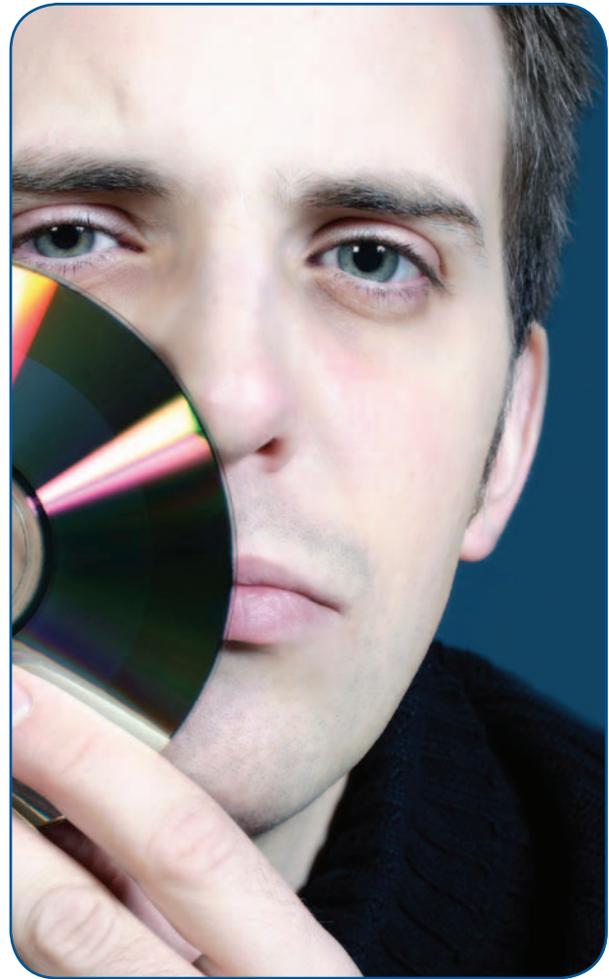
The market approach may not work because comparable transactional data for IP and other intangible assets is difficult to obtain. Some assets — such as trademarks, trade names or brands — are rarely bought and sold in the marketplace. And even for assets that are sold, such as copyrights and patents, transactional data may not be published.

In light of these limitations, the RFR method can be an effective alternative. RFR is categorized as an income-based method (somewhat similar to the discounted cash flow approach), although it may also share some attributes of the market and cost approaches.

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METHOD IN ACTION

The RFR method estimates the portion of a company's earnings that are attributable to an IP asset based on the royalty rate the company would have paid for the use of the asset if it didn't own it. In other words, the asset's value is equal to the value of the royalty payments from which the company is relieved by virtue of owning the asset.



A valuator applies the method by selecting a royalty rate based on available market data for licenses involving similar assets, industries, territories and other characteristics. Then the valuator selects an appropriate, risk-adjusted discount rate to determine the present value of the royalty payments.

Typically, this hypothetical license is treated as a perpetual license. To estimate the value, the valuator calculates the present value of projected royalty payments over a certain period (for example, 10 or 15 years) and then calculates the present value of the residual at the end of that period.

TIME-TESTED METHOD

Although the RFR approach may be new to you and your clients, professional valuers have been using it for many years. Whether you're valuing IP for litigation, sale or tax purposes, RFR may be the best method of reaching an accurate appraisal. ▀

Romano v. Steelcase

How “private” are social network posts?

Social networking sites such as Facebook and MySpace, which allow members to share information about their personal lives and activities, have become a rich source of evidence for attorneys. The case law on a party’s right to access an opponent’s profile and other online information remains in flux. But recently, a New York court found that the inherently public nature of social networking sites undermines any expectation of privacy.

UNDERMINING PLAINTIFFS’ CLAIMS

The plaintiff in *Romano v. Steelcase*, Kathleen Romano, brought a personal injury action against Steelcase, Inc., claiming to have sustained permanent neck and back injuries. Romano asserted that she could no longer participate in certain activities and that her injuries had affected her enjoyment of life.

Romano had accounts on Facebook and MySpace, social networking sites that allow members to set privacy levels to control who can see their information. After a review of the public portions of Romano’s Facebook and MySpace pages, Steelcase sought full access to and copies of the current and historical information posted on Romano’s pages. Steelcase contended that the public portions revealed that Romano had an active lifestyle and had traveled to Florida and Pennsylvania during the period she claimed her injuries prohibited such activities.

The court held that the information Steelcase sought was both material and necessary to its defense. Noting that the public portions contained material that was contrary to Romano’s claims, it found there was a reasonable likelihood that the

private portions might contain additional evidence, including information relevant to her activities and enjoyment of life.

PRIVACY CONCERNS

Romano argued that production of her Facebook and MySpace accounts would violate her right of privacy, but the court disagreed. It pointed out that, when she created her accounts, she agreed that her personal information would be shared with others, notwithstanding her privacy settings.



Because she knew that her information might become publicly available, the court said, she couldn’t now claim that she had a reasonable expectation of privacy.

The court further found that Steelcase’s need for access outweighed any privacy concerns: “The materials including photographs contained on these sites may be relevant to the issue of damages and may disprove” Romano’s claims. Without access, the court found, Steelcase would be at a “distinct disadvantage” in defending itself.

EVIDENTIARY TREASURE TROVES

Information found on social networking sites potentially can play a pivotal role in a variety of cases, including personal injury, insurance fraud and divorce. As some courts and commentators have made clear, any expectation of privacy for such information is more wishful thinking than reality. Working with computer forensics experts, attorneys should routinely make — and expect to field — discovery requests for full access. ▀