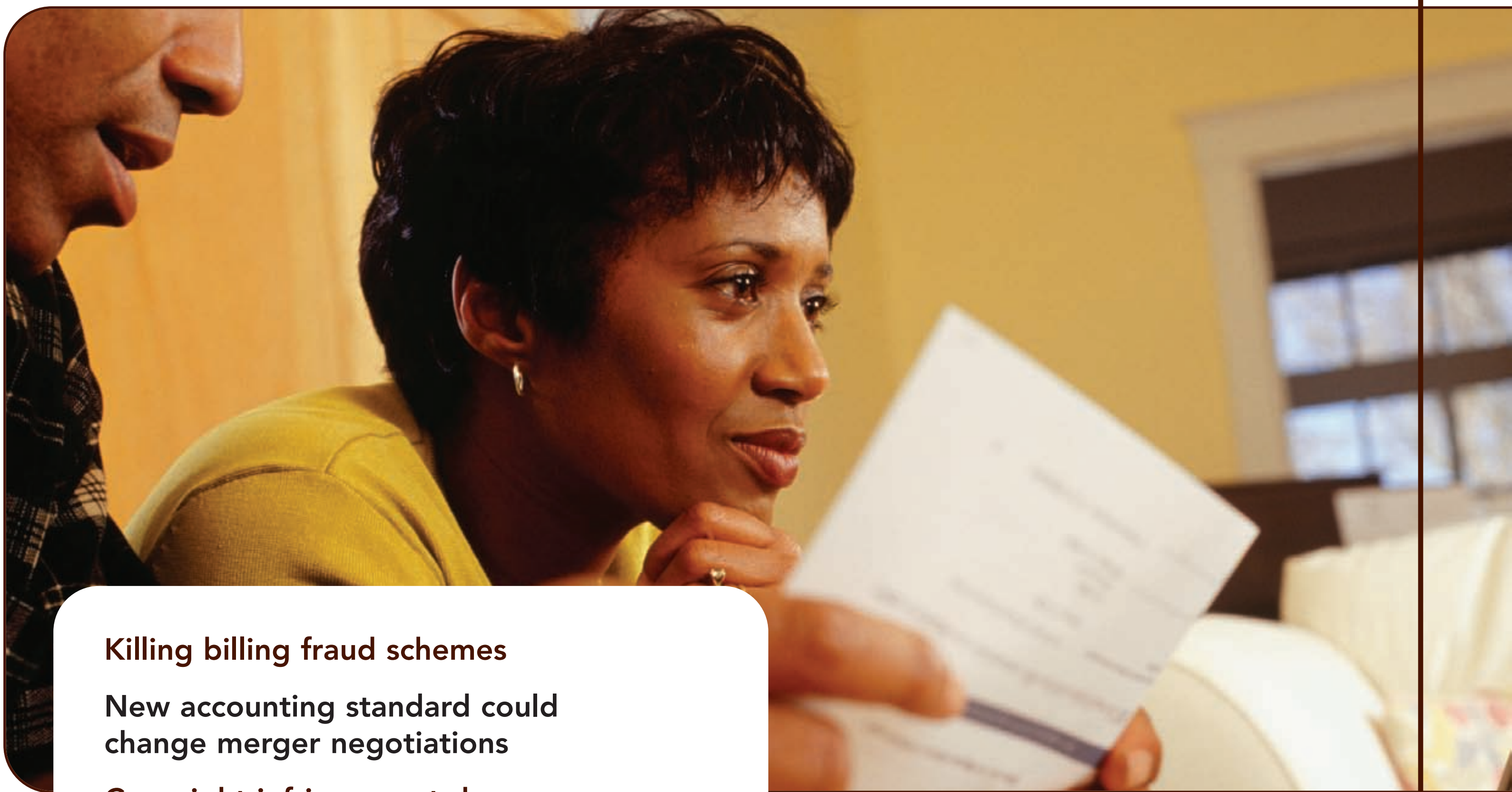
Advocate's EDGE



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Killing billing fraud schemes

Employee billing fraud can take a big bite out of a company's profits; the Association of Certified Fraud Examiners estimates the median associated loss at $130,000. Motivated by the potential for big rewards, thieves have come up with a variety of billing fraud schemes. But businesses and their legal advisors can help prevent large losses and possibly enhance their chances of a successful prosecution if they know the signs of this type of fraud. Here's how fraud experts uncover them.

PASS-THROUGH SCHEMES

With pass-through schemes, employees, such as purchasing agents or other individuals authorized to approve invoices, form a shell company to purchase goods for the employer. They then mark up the price on the goods and re-sell them to the employer.

This type of fraud can be uncovered by comparing purchase expenses from previous periods with the current period. Significant price increases without a reasonable explanation (such as market shortages) could suggest billing fraud and, thus, merit further investigation.

SHELL COMPANIES

Here, employees create a fake entity to bill the employer for goods and services the employer doesn't actually receive. Typically, perpetrators obtain a fictitious name certificate from a local government or invent a name similar to that of a pre-existing vendor and then open a business account at a bank in that name. Next, thieves submit phony invoices from their shell company to their employer. As with pass-through schemes, this type usually requires the involvement of an employee who can approve invoices and add accounts to the company's master list of approved vendors.

Dishonest employees might cause an overpayment to an actual vendor and, when the vendor returns the overpayment, pocket the refund.

Fortunately, shell company fraud leaves a paper trail, though locating the phony documents may require some digging. Fraud experts generally begin by scrutinizing line-item costs over a multiyear period for unusual trends or items. In particular, they pay close attention to billings for expenses that are difficult to quantify (and, therefore, validate), such as consulting, contracted employees and advertising.

PERSONAL PURCHASES

Employees may improperly charge merchandise to their employers and either put the goods to personal use or return them for a cash refund. They could, for example:

- Use their position to approve invoices for personal purchases,
- Forge approval on purchase requisitions,
- Alter purchase orders to increase the amounts delivered and then siphon the extras, or
- Abuse company credit cards.

In the last case, a billing scammer might make purchases online using company credit cards and request that the goods be delivered to a different address.

Experts gather evidence of this type of scheme by comparing shipping reports with amounts recorded as received. They also review invoices for anything unusual (such as an invoice to a manufacturing company from a seller of electronic goods) and delivery addresses other than the employer's.

PAY-AND-RETURN SCHEMES

Dishonest employees might cause an overpayment to an actual vendor and, when the vendor returns the overpayment, pocket the refund. For example, an accounting department employee could process a legitimate invoice twice by making a copy of the original. He or she processes and approves the original and repeats the actions days later for the copy. The employer pays both invoices and, when the vendor sends a refund check, the employee nabs the check and forges the employer's endorsement.

In another version of this scheme, a fraudster might use a shell company with a name similar to that of the employer and replace the employer's Form 8109 coupon with the shell company's taxpayer identification number. Payroll tax refunds, therefore, are sent directly to the employee.

A fraud expert will look for duplicate invoices that may not be apparent to untrained eyes. Experts can also help companies establish internal controls that will catch multiple invoices before they're paid. Anonymous tiplines could prove worthwhile, as well, because co-workers often are the first to witness or suspect billing fraud.

BILLING SCHEME RED FLAGS

Even before they call in financial experts, owners need to be on the lookout for warning signs. Items that should raise suspicion, if not actual alarm, include:

- Invoices for vague consulting or similar services, or a significant increase in consulting expenses,
- Vendors with names that include initials, which may be a fraud perpetrator's,
- Unknown vendors,
- Vendors that bill more often than once a month,
- Vendor addresses that correspond with employee addresses, and
- Vendors that use a post office box for invoice payments.

Invoice amounts that consistently come in just below a threshold that would normally trigger the owner's review or an additional manager's approval further merit attention.

STOP THE CASH DRAIN

As soon as reasonable suspicions arise, you and your client should consult a fraud expert. The earlier you enlist the help of a forensic accountant, the more likely this expert will be able to uncover evidence, identify the perpetrator and prevent further, possibly significant, losses. ◗

New accounting standard could change merger negotiations

Late last year, the Financial Accounting Standards Board (FASB) issued a revision of the accounting rules for mergers and acquisitions (M&As). FASB Statement No. 141R, *Business Combinations*, updates the earlier FASB Statement No. 141. It expands the scope of covered business combinations, revises the treatment of transaction costs and addresses the recognition of intangible assets, bargain purchases and contingencies. These changes could affect the value of an M&A deal.

NOT FOR EVERYONE

FASB 141R applies to all transactions in which an entity obtains control of one or more businesses — a broader scope than transactions covered under FASB 141. Previously, combinations achieved, for example, by contract alone or through the lapse of minority veto rights weren't covered. But the revision includes transactions such as these that don't include the transfer of consideration.

at fair value as of the acquisition date. This could complicate the valuation process — forcing deal participants to determine the fair value of consideration that may or may not be received in the future.

RECOGNIZING TRANSACTION COSTS

Under the old standard, a buyer was required to include transaction costs in the cost of acquisition allocated to assets and liabilities. But FASB 141R requires separate recognition of these costs. It also mandates separate recognition of restructuring costs the buyer expects but isn't obligated to incur. Previously, restructuring costs were recorded as an assumed liability at the acquisition date.

Yet, not every combination need comply. Joint ventures don't fall within FASB 141R's purview. Nor do acquisitions of assets or groups of assets that don't constitute a business (such as real estate or a product line). Also exempt from the rule are combinations between entities or businesses under common control, combinations between nonprofit organizations and acquisitions by nonprofits of for-profit businesses.

FAIR VALUE TAKES OVER

Transactions covered by FASB 141R must be reported using the acquisition method (previously known as the purchase method) of accounting. A buyer is now required to allocate the purchase price to all assets acquired (including intangibles), liabilities assumed *and* minority interests in the seller — generally at fair value as of the acquisition date.

FASB 141 didn't recognize contingent consideration as a component of purchase price until the contingent payment was actually made or was issuable — for example, when the acquired company met a revenue or net income benchmark. But under FASB 141R, fair value applies to contingent consideration as of the acquisition date.

The new standard also asks buyers to recognize assets and liabilities stemming from contractual contingencies

This new treatment of transaction costs could play a role in purchase price negotiations. Because legal, accounting, valuation and consulting fees must be expensed as incurred, rather than included in the purchase price, the acquirer's earnings could suffer. Reduced earnings, therefore, may warrant negotiations for a reduced purchase price.

GOODWILL AND BARGAIN PURCHASES

FASB 141R also affects the recognition of goodwill, requiring buyers to recognize it as of the acquisition date and measured as a residual. Residual typically is the excess of the consideration transferred, plus the fair value of any minority interest in the selling company, over the fair values of the identifiable net assets acquired.

The revised standard defines a "bargain purchase" as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred, plus any minority interest in the seller. The earnings excess is recognized as a gain attributable to the buyer. Under the earlier standard, the excess was deemed negative goodwill to be allocated as a pro rata reduction of the amounts otherwise assigned to particular assets acquired.

ONE STEP AT A TIME?

In some combinations, the buyer obtains control of the selling company in steps over a period of time. FASB 141 allowed buyers to identify the cost of each investment, the fair value of the underlying identifiable net assets acquired and the goodwill involved in each step. Thus, assets and liabilities were measured as a blend of historical costs and fair values.

FASB 141R revises the accounting for phased acquisitions. Now, buyers must record 100% of the fair value of all assets, liabilities and minority interests at the acquisition date, regardless of when buyers will assume control of them.

THE LONG ARM OF THE STANDARD

The revised standard applies to deals completed on or after the beginning of the first annual reporting period that begins on or after Dec. 15, 2008. In addition to the changes discussed above, FASB 141R makes significant amendments to other FASB statements and authoritative accounting guidance, including FASB 142, *Goodwill and Other Intangible Assets*.

The changes are expected to have widespread repercussions, so talk to your financial expert. He or she can explain how their effects might trickle down to your clients' M&A deals and possibly call for them to adjust their merger process.

Copyright infringement damages

The lowdown on a complicated calculation

Since Congress first passed the 1976 Copyright Act, infringement litigation has maintained a healthy level. Because the Internet has only increased opportunities for allegations of copyright infringement, you're likely encountering more of these types of cases and wrestling with potential remedies, including actual damages. Don't do it alone.

ACTUAL DAMAGES

Under the Copyright Act, copyright holders are generally entitled to recover actual damages suffered as a result of infringement.

Defendants can present multiple approaches to support their proposed damages calculations and, ideally, minimize their liability.

Actual damages can be measured by market value or lost profits. The market value approach examines prior dealings and trade custom to arrive at a value for the copyright before and after the infringement. Most financial experts, however, use the lost profits approach, which can use a variety of methods, depending on the circumstances of the case.

LOST SALES

To calculate lost profits, the first step generally is to determine lost sales. These may be based on one or more of the following:

Infringer's sales. The copyright holder may allege that, if not for the infringement, its sales of the protected work would have increased in an amount equal to the infringer's sales. Unless the holder's and infringer's products are comparable in terms of price, customers, distribution, packaging and advertising, a court will likely reject this approach, though.

Overlapping customers or diverted sales. This theory holds that the copyright holder lost some of its former customers to the infringer. In other words, if not for the infringer, those customers would have purchased from the copyright holder. Comparability, such as a common customer base, must again be established.

Sales projections. If the copyright holder has maintained records of its projected and actual sales for earlier financial periods, it may be possible to establish a historical correlation between the figures. This correlation can support the use of sales projections as a basis for measuring lost sales. The accuracy of past projections is insignificant as long as the relationship between the projections and the actual past sales remains stable.

Product mix. Sales of different products may also indicate lost sales. Sales during periods of both infringement and noninfringement, and in both infringed and noninfringed market segments, need to be analyzed to establish benchmarks for projecting the product mix relationships in the absence of the infringement.

Courts might also give weight to changes in the size of the market, sales of alternative products and related market trends. By presenting multiple approaches that reach similar amounts, copyright holders greatly increase their chances of prevailing. Defendants can also present multiple approaches to support their proposed damages calculations and, ideally, minimize their liability.

DEDUCTIONS AND OTHER COMPLICATIONS

Several other factors bear on actual damages. For example, after the amount of lost sales is determined, a deduction must be made for the costs and expenses that the copyright holder would have incurred to generate those sales. Conversely, the holder's lost interest or earnings on the lost sales may be added to the amount.

In addition, the Copyright Act allows the copyright holder to recover the infringer's profits that were attributable to the infringement and not already taken into account in the lost sales calculation. But some of the infringer's sales may be due to factors other than the infringed work.

It may be necessary to determine the portion of the product's value that's provided by the infringed work. Or, the infringed work may be closely intertwined with other product elements, complicating the calculation and requiring detailed analysis and multiple regression models. Either way, infringers must prove the elements of profit attributable to factors other than the copyrighted work and their deductible expenses.

STATUTORY DAMAGES

Copyright holders may receive statutory damages if the court finds insufficient evidence to support a calculated award — or if the holder elects statutory damages in lieu of actual damages. These damages, however, carry statutory per-infringement caps: not less than $750 or more than $30,000 per infringement.

Where the infringer has willfully infringed a copyright, a court may increase the award of statutory damages to a sum of not more than $150,000. Where, however, the infringer proves that it wasn't aware, and had no reason to believe, that its acts constituted copyright infringement, the court may reduce the award of statutory damages to a sum of not less than $200.

THE BOTTOM LINE

Determining copyright infringement damages requires the consideration of more than mere financial statement profits; it requires complicated calculations. To ensure the best outcome, both plaintiffs and defendants should retain a financial professional to determine damages a court is likely to accept.

DOES USE AFFECT DAMAGES?

In *Thoroughbred Software Int'l v. Dice Corp.*, the Sixth Circuit Court of Appeals found an infringer liable for damages even though the unauthorized copies weren't used.

A software licensing agreement required Dice to obtain a license and pay a license fee to Thoroughbred for each copy purchased, except for one backup copy. Thoroughbred discovered that Dice had dozens of unauthorized installations of its software, though not all were actually in use. Dice claimed it had made the infringing copies merely as a matter of convenience. If one of Dice's customers subsequently wanted to activate a module, Dice would contact Thoroughbred to obtain authorization and submit payment.

The court found that Dice had breached the licensing agreement, providing the requisite causal connection between the unused infringing software and Thoroughbred's actual damages. Dice was held liable for the unpaid license fees for all of the unauthorized copies.

Court delivers another lesson on FLP structuring

The Ninth Circuit Court of Appeals has come down on the side of the IRS in another tax case involving a family limited partnership (FLP). The court, in *Bigelow v. Commissioner*, found that the decedent's gross estate must include the full fair market value of property that had been transferred to the FLP. This ruling reinforces the notion that, when it comes to FLPs, substance is more important than form.

BIGELOW'S BACKGROUND

Virginia Bigelow created a revocable trust and transferred her home to it in 1991. Then, in 1993, the trust exchanged the home for another home. In 1994, when Bigelow was 85 and living in an assisted-living facility, she and her children formed an FLP, with the trust as sole general partner and also a limited partner.

The home was transferred to the FLP — its only asset — but Bigelow remained personally liable for the mortgage. The transfer, however, caused a deficit between her monthly income and expenses because she no longer received rental income from the home, and the FLP's net income was used to cover her living expenses. After Bigelow died, the home was sold, and the proceeds were distributed to the remaining limited partners — the first FLP distributions they had received.

THE COURT WEIGHS IN

Under Internal Revenue Code Section 2036(a)(1), property transferred by a decedent during his or her life is still included in the gross estate if the decedent retains "the possession or enjoyment of, or the right to the income from, the property," except in case of a bona fide sale for an adequate and full consideration. The court here found an implied agreement among Bigelow and her children that she would retain the right to the income from the home.

The court noted that Bigelow had continued to use the home to secure debt and that the FLP had paid her monthly mortgage payments without making adjustments to her trust's capital account, as required by the partnership agreement. Further, the record "supported the finding that in the absence of an implied agreement, [Bigelow] would have been impoverished and unequipped to meet her financial needs."

The court also rejected the estate's argument that the transfer constituted a bona fide sale for adequate and full consideration, finding no legitimate nontax business purpose. It did, however, "agree with the Third and Fifth Circuits and the Tax Court that an *inter vivos* transfer of real property to [an FLP], which inherently reduces the fair market price of the resultant partnership interests, does not *per se* disqualify the transfer from falling under" the bona fide sale exception.

FOUNDATIONS COUNT

Bigelow follows several other FLP cases in which the IRS prevailed. Here, as in those, the decedent failed to retain sufficient non-FLP assets for living expenses; the FLP didn't observe partnership formalities; the estate failed to offer evidence of the FLP's legitimate nontax purpose; and the partners did not pool assets. It doesn't have to be this way, though. If you work with your client to properly structure an FLP, it's likely to withstand an IRS challenge.