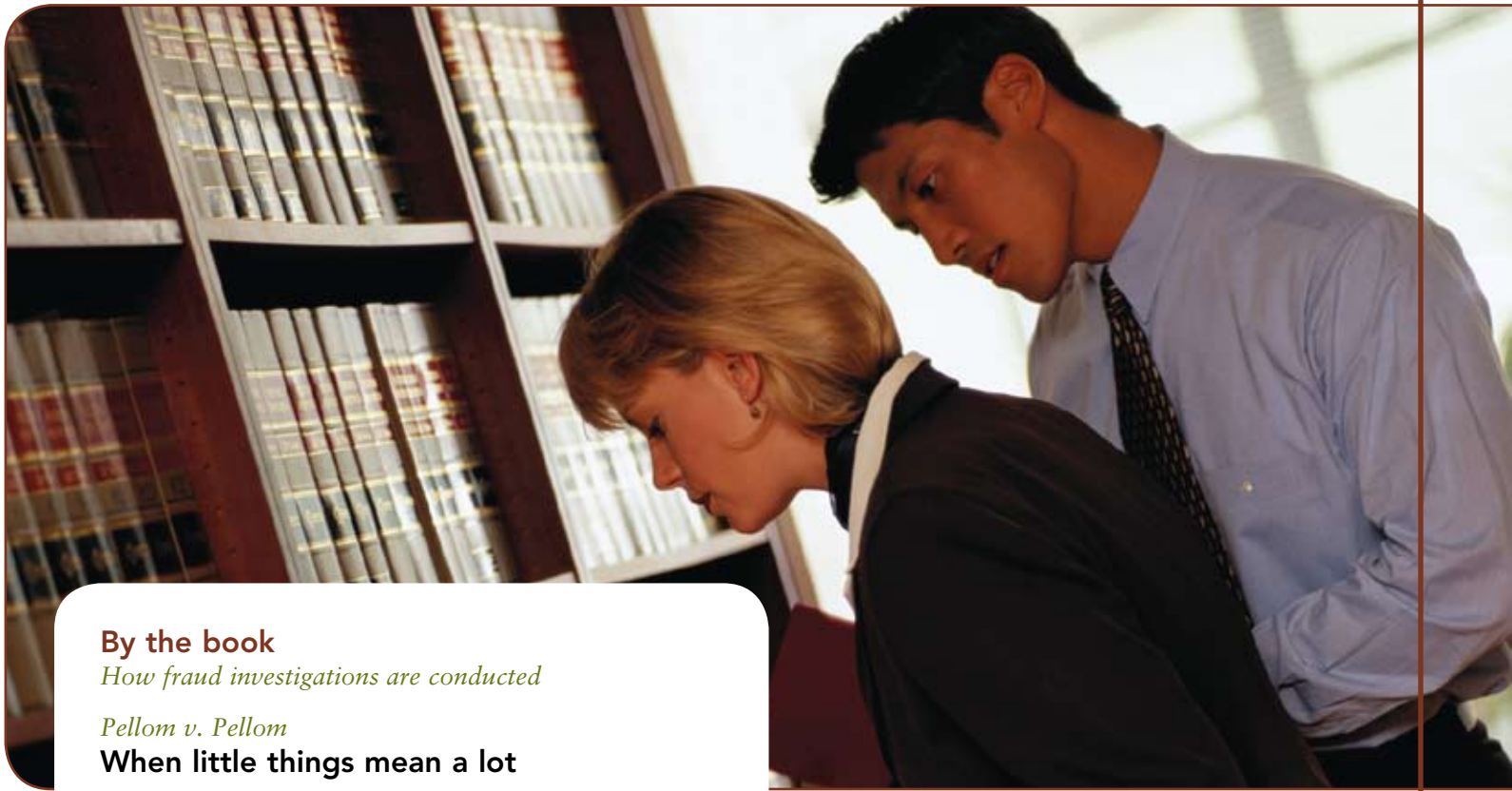


— Advocate'sEDGE —



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September/October 2009

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How fraud investigations are conducted

Despite their best prevention efforts, your clients are likely to suffer incidents of occupational fraud. When they do, they'll need the assistance of a fraud expert, perhaps to find the perpetrator, or at minimum to collect evidence.

A joint guide, *Managing the Business Risk of Fraud: A Practical Guide*, published by the American Institute of Certified Public Accountants (AICPA), the Association of Certified Fraud Examiners (ACFE) and the Institute of Internal Auditors (IIA), outlines the approach a qualified expert will take to execute an effective and coordinated fraud investigation. By understanding how your expert will conduct the investigation, you can ensure you're providing the information and assistance necessary for it to be successful.

APPROPRIATE PROCESSES

Fraud investigations involve a variety of steps designed to protect the business, minimize disruptions and preserve evidence. According to the joint guide, every fraud investigation should include a process to:

- ▶ Categorize issues,
- ▶ Confirm the validity of the allegation,
- ▶ Define the severity of the allegation,
- ▶ Escalate the issue or investigation when appropriate,
- ▶ Refer issues outside the scope of the program, when appropriate,
- ▶ Conduct the investigation and fact-finding,
- ▶ Resolve or close the investigation,
- ▶ List types of information that should be kept confidential,
- ▶ Define how the investigation will be documented, and
- ▶ Manage and retain documents and information.

Work with your expert and client to determine the appropriate process for the particular matter at hand. The client must grant the expert sufficient authority to conduct the investigation and work with internal departments — including human resources, in-house counsel, senior management, IT, internal auditing, and security and loss-prevention.

3 STAGES

Thorough planning is a prerequisite to launching a fraud investigation. The plan developed by you and your expert should prioritize investigatory tasks to facilitate an interim report of findings (if required), but also allow for revision. Tasks typically belong to three primary stages:

1. Interviews. The expert will interview third-party witnesses, corroborative witnesses, possible co-conspirators and the alleged perpetrator or perpetrators.

2. Evidence collection. To gather relevant evidence, the expert will target both internal documents and external records. The former includes personnel files, internal phone records, e-mail, financial records, security camera tapes,





and physical and IT system access records. The expert may need to perform computer forensic examinations to locate this evidence. External records could include public records, customer and vendor information, media reports, and private detective reports.

3. Evidence analysis. The expert will review and categorize the information collected, conduct computer-assisted data analysis and test various hypotheses. He or she will document and track every step in the investigation. Appropriate documentation covers privileged or confidential items; requests for documents, electronic data and other information; memoranda of interviews; and analysis of documents, data, interviews and conclusions drawn.

The expert also will provide a report of his or her findings. You may determine the appropriate format for the report and how distribution will be affected by the need to protect legal privileges and avoid defamation.

CORRECTIVE ACTIONS

To minimize its legal liability, a company must take some corrective action in response to an expert's fraud findings. When necessary to maintain confidentiality, preserve evidence or mitigate losses, the company may even consider taking action *before* the investigation is complete. It might, for example, suspend or reassign an employee or commence legal action to restrain specific assets.

After the expert has completed the investigation, the company can make a criminal referral and may even be required to do so by law. Alternatively, the company might pursue civil litigation, impose disciplinary action, file an insurance claim, extend the investigation, or revise business processes or internal controls.

CONTAINING FRAUD

Every company should take a proactive stance toward risk management to minimize its exposure to fraud losses. But when fraud slips through the cracks, a qualified expert can help ensure a timely and comprehensive investigation. ▸

CUSTOMIZING THE INVESTIGATION

Managing the Business Risk of Fraud: A Practical Guide notes that consistency in investigatory processes is important, but it recognizes that several factors will influence the plan for a specific investigation. For example, in the case of time sensitivity, deadlines may be imposed by legal requirements, the need to mitigate losses or harm, or insurance claims restrictions.

Other factors that may influence the investigation plan include:

Notification. The company may be required to notify regulators, law enforcement, insurers or auditors.

Confidentiality. The investigation must ensure confidentiality for certain collected information.

Legal privileges. The company's attorney and the expert must agree in advance on the proper measures to protect work product and attorney-client communications.

Compliance issues. The investigation must comply with applicable laws and rules regarding the gathering of information.

Pellom v. Pellom

When little things mean a lot

Have you ever had a case where it seemed as though the opposing valuation experts were assessing entirely different businesses? You might have thought so in a recent North Carolina appellate court case, *Pellom v. Pellom*. Fortunately for the wife in this divorce matter, her valuation expert constructed a textbook foundation for his numbers.

ABUSE OF DISCRETION?

The Pelloms separated on June 9, 2004, and the physician husband filed for divorce on Feb. 7, 2005. The husband's expert valued his 11.11% interest in an anesthesiology practice at \$183,000, and the wife's expert put the value at more than \$1.2 million.



The trial court accepted the wife's valuation without adjustment. On appeal, the husband argued that the trial court had abused its discretion regarding the valuation. He alleged that the wife's expert had used an incorrect figure for the husband's "normalized income." Normalized income was compared to that of similarly situated physicians to calculate the value of the husband's interest.

The husband's income rose steadily between 1999 and 2003, and the wife's expert used a figure of \$525,000 (a little less than the 2003 earnings, which was the highest salary between 1999 and 2005) as the husband's normalized earnings. The expert didn't consider the husband's 2004 and 2005 earnings, but his report was dated as of June 9, 2004. The court of appeals therefore held that the expert had "properly valued the business at the date of separation with the data he had at the time."

PROCEDURES AND PERCENTAGES

The husband also asserted that the wife's expert's income figure for similarly situated anesthesiologists was incorrectly calculated. The trial court accepted a figure that put the husband in the 75th percentile in compensation, according to the 2003 version of the Medical Group Management Association (MGMA) physician compensation data.

The husband claimed that the expert shouldn't have relied on that version because the 2004 version was available at the time of his report. The expert had, however, noted on his report that the "2004 MGMA report corroborates with 73%." The appellate court concluded that accepting figures based on the 2003 report didn't constitute an abuse of discretion.

The husband also argued that the expert should have placed the husband in the 90th percentile of compensation based on the number of procedures performed by the practice and corresponding MGMA statistics. In the MGMA data, the 75th percentile physicians performed an average of 1,153 procedures per year; the 90th percentile physicians performed an average of 1,400 procedures.

The husband's anesthesiology practice performed about 20,000 procedures per year — or, the husband's expert claimed, about 2,000 per physician. The trial court, though, found that the husband's expert hadn't accounted for the number of procedures

that were performed by the practice's 31 certified registered nurse anesthetists.

The husband asserted that the wife's expert's income figure for similarly situated anesthesiologists was incorrectly calculated.

TAXING ISSUES

The husband further contended that the trial court had improperly failed to consider the tax consequences when accepting the wife's expert's valuation. The court of appeals noted that, under North Carolina law, a trial court isn't required to consider possible taxes when determining the *value* of property in the absence of proof that a taxable

event has occurred during the marriage or will occur with the division of the marital property.

It found that the trial court here had complied with the relevant law by considering the tax consequences that would result from the distribution of property actually ordered. The appellate court pointed out that the husband was ordered to pay a distributive award, not to liquidate his interest in the practice, which might have had significant tax consequences.

A FULL AND FAIR ACCOUNTING

For all of the husband's arguments, it appears the primary reason for the discrepancy between the two experts' valuations was the husband's expert's failure to account for the practice's goodwill. In fact, the trial court refused to accept his valuation for this very reason. *Pellom*, therefore, provides more evidence that a faulty foundation can undercut an entire valuation, and that attorneys need to select their experts carefully. ▸

Broke . . . or dishonest?

Uncovering alter ego companies

Chrysler's and GM's recent bankruptcy filings were very public examples of a much broader insolvency trend that cuts across all industries and market capitalizations. Most companies filing for bankruptcy accurately represent their assets. But a small percentage of filers that claim to have little or nothing to offer creditors aren't being honest. Instead, they've diverted resources to an alter ego company or are hiding their connection to a much healthier corporate parent.

If your clients have claims against bankrupt businesses or are involved in litigation with purportedly poor defendants, you might want to look into the existence of an alter ego company. Uncovering and proving this type of fraud can be difficult, but forensic accounting experts know

how to expose such schemes. Conversely, forensic experts can help defendants prove that any alter ego accusations are unfounded.

SOMEONE'S HIDING SOMETHING

Alter ego companies are, in a nutshell, fake businesses set up by parent companies with something to hide. Typically, owners divert assets, such as inventory and accounts receivable payments, from the parent to the alter ego before the parent lands in bankruptcy court. Alter ego schemes are also commonly used to hide assets in marital dissolutions and shareholder disputes.

If no legal connection between the two companies exists or can be proven, the alter ego's assets are

protected. If the relationship can be established, however, claimants or plaintiffs may be able to hold the other entity or its shareholders liable. Laws vary by state, but most require evidence of a unity of interest between the corporation and the other person or entity — indicating that they have no separate existence and that allowing the corporate fiction of a separate entity would, under the specific circumstances, sanction fraud or promote injustice.

Typically, owners divert assets from the parent to the alter ego before the parent lands in bankruptcy court.

Proving an alter ego case can be complicated by the fact that it's perfectly legal for corporations to limit risk by setting up separate, subordinate businesses. But even if they're wholly owned by the parent, legal entities maintain their own corporate structures and function independently in terms of sales, billings, assets and management.

SMELLING A RAT

Experts look for a variety of signs that may indicate the existence of an alter ego company. For example, red flags go up if both companies:

- ▶ Operate out of the same location,
- ▶ Have similar names,
- ▶ Use the same letterhead or Web site,
- ▶ Sell identical products,
- ▶ Pay each other's expenses,
- ▶ Follow the same policies and procedures, or
- ▶ Share officers and directors or outside advisors.

Forensic accountants also examine the number and nature of “related party” transactions which, to be legitimate, must not include special or favorable terms and conditions. Otherwise, these transactions may represent a route for diverting money from the bankrupt or defendant company — thereby making it insolvent and judgment-proof.

When the alter ego is a defendant, experts might look at when the parent incorporated the subsidiary. They also investigate whether the parent has recently pulled cash out of its subsidiary or deposited the subsidiary's accounts receivable in its own bank account.

POPULAR IN TROUBLED TIMES

Alter ego scams aren't new, but in times of widespread financial distress they — as well as other fraud schemes — are more common. If you suspect an alter ego is interfering with your ability to recover what's due a client, ask a forensic specialist to investigate. Not only can these experts establish relationships between companies, but they also can help explain in court how such complex associations attempt to defraud creditors and plaintiffs. ▶



User-created data: Handle with care

Production of electronically stored information (ESI) has become a routine part of discovery. But the primary target of an ESI request often is user-created data — a type of information that is constantly evolving and can prove elusive. A qualified expert can help extract all the user-created data you need.

NORMAL BUSINESS PROCESS

Unlike system- or application-created data such as metadata or temporary files, user-created data comprises files with information generated by a user as part of the normal course of business. For a typical office worker, user-created data might result from:

- ▶ Sending e-mail,
- ▶ Using Microsoft Office (Word, Excel®, PowerPoint® and Access®) programs or similar software,
- ▶ Searching the Internet, and
- ▶ Sending instant messages.

Each of these kinds of activities produces different types of electronic files. E-mail related files, for example, include those ending with .msg, .eml and .pst.

Finding user-created data may seem straightforward, but the rapidly changing nature of software can complicate the process of locating necessary files. As businesses adopt new software applications or update versions of old standbys, their users begin to produce new kinds of files.

For example, most businesses that have been around for 15 or more years have progressed from .wpd files to .doc files, as the businesses moved from using WordPerfect® to Microsoft Word. And now .doc files are being replaced (albeit more slowly than originally expected) by the .docx extension associated with Microsoft Office 2007.

AN ELUSIVE TARGET

A qualified forensic expert can help you and your client sort through the potential file types on the client's (or opponent's) system and focus on those most likely to contain relevant information. Although it may be possible to comb through every type of file, it probably won't be cost-effective.

An expert will work with you and your client to develop a list of file types with potentially relevant user-created data. The list will be used to extract data from hard drives and servers, but the expert's approach will vary, depending on whether he or she has access to a forensic image. Note that, to prevent the corruption of critical evidence, forensic images of servers and drives should be made *before* anyone searches or reviews their files.

SHIFTING SAND

Computer software is constantly evolving, so the types of files that hold valuable user-created data will remain fluid. Experts who understand which drives and servers need to be searched for relevant files and data are essential partners in the discovery process. ▶

