fraud alert

year end 2003

Fair and square

Calculating fraud damage awards

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Who's reading your clients' e-mail?

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Fair and square

CALCULATING FRAUD DAMAGE AWARDS

If your client has been defrauded, proving the case is only the first step — Step 2 is making sure he or she receives compensation for all losses. And that means calculating damages. It's a widespread misconception that working out fraud damages is just a matter of "common sense." In fact, satisfying the court as to damages' fairness can involve complicated research and calculations. So at this crucial stage, counsel often calls in a forensic accountant.

What makes measuring fraud damages so involved? With special rules and methods, fraud cases differ from breach of contract or other business dispute cases. The forensic accountant must decide, based on the type of transaction, what kind of damages the client can reasonably expect. The expert then evaluates all other transactions that suffered because of the fraud and chooses the best method to calculate lost profits. Expert calculations are a challenging process but using them increases the chance that justice for your client will prevail.

THE BEST RULE

In the world of damage computations, two major rules exist — the out-of-pocket-loss rule and the benefit-of-bargain rule. Under the out-of-pocket-loss rule, the plaintiff is entitled to recover only the money invested. But using the benefit-of-bargain rule, the plaintiff may also recapture profits that could have been earned with a similar investment.

For example, suppose the plaintiff paid $5,000 for a diamond bracelet, which the seller said was worth $100,000. However, its fair market value is only $50,000. Under the out-of-pocket-loss rule, the plaintiff suffered no damages because the bracelet's fair market value was $45,000 more than he or she paid. But the benefit-of-bargain rule results in damages of $50,000, the difference between the value of what the buyer received ($50,000) and the value promised ($100,000). In other words, damages don't depend on the selling price.

How do experts decide which rule to use? If a transaction comprises buying, selling or exchanging property, the out-of-pocket-loss rule governs in most states. For transactions involving services or not involving property, the benefit-of-bargain rule applies.

THE RIGHT CALCULATION METHOD

Forensic accountants use a two-step process to actually calculate damages. First, they sum up all fraud-affected transactions, then calculate the potential lost profit (money the client would have made if the fraud had not taken place).

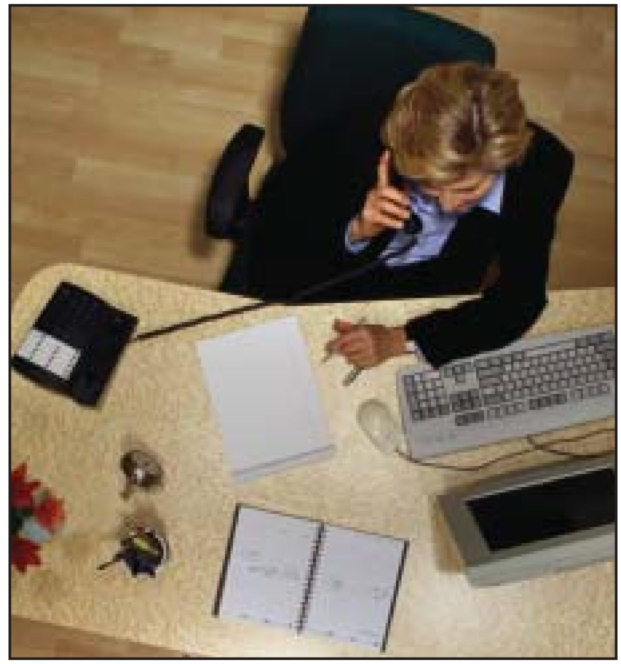
The case's specifics dictate how the expert tailors the methods and computes the damages. What's the best method? The one that makes the most sense to the court and brings the plaintiff appropriate compensation. To calculate lost profit, the expert usually chooses one of the following three methods, or uses elements of more than one.

1. ***Before-and-after method.*** This compares the plaintiff's "before fraud" and "after fraud" profits. The expert splits before and after profits into the damage periods or fiscal periods the fraud affected. For each damage period, he or she then subtracts the after profit from the before profit. The difference is the damage period's lost profit. Adding all lost profit for each damage period produces the total lost profit figure.

2. ***Yardstick (benchmark) method.*** This analyzes the client's lost profit by comparing his or her *actual* profit to that of a similar business untouched by fraud, using the comparable businesses' profit as the benchmark. Experts often employ this method when dealing with start-up businesses or those lacking a history of profitable operations. The mechanics of calculating the loss are similar to those of the before-and-after method.

The best method is the one that makes the most sense to the court and brings the plaintiff appropriate compensation.

3. ***Hypothetical-sales (model) method.*** Here, the expert compiles marketing data, such as the size of the market to have been served and the market share to have been realized. He or she calculates lost revenue based on these assumptions and estimates. The next step is to subtract estimated costs and expenses from revenue to determine lost profit.



For example, if a company suffered a fraud that caused a major segment to temporarily shut down, it would probably suffer lost revenue and profit. The forensic expert, using comparable industry information, can project the potential revenue that the business's inactive segment would have generated, and its relevant operational costs. The lost profit is the difference between the potential revenue and the estimated costs.

Experts rarely use the hypothetical sales method as a stand-alone because it's hard to accurately project future profit, and therefore easy to challenge the computation in court. However, it can be helpful as a supplement to the before-and-after and yardstick methods.

RIGHTED WRONGS

Once you've won a fraud case, you'll naturally want to restore as much of your client's lost profit as possible. If your client has been defrauded and you're seeking fair damage compensation, please give us a call. We can review the case with you, analyze the fraud's financial effects and advise you of the best method to calculate your client's losses, present them to the court and bring about an equitable payment.

When divorce looms, shared funds can disappear

Every new couple dreams of a successful marriage, but not everyone's dreams come true. And it's a sad fact that once divorce looms, some spouses go out of their way to hide or undervalue marital assets. The result: The other spouse doesn't receive his or her legitimate share of the money and property they acquired during the marriage.

When their divorcing clients suspect foul play, many attorneys retain forensic accountants to trace funds, evaluate the spouses' financial reports, and value their businesses and investments. These experts also can testify in court or assist you in preparing a courtroom presentation. If you believe a client's spouse is diverting significant marital assets, the benefits of retaining a financial expert will likely outweigh the costs.

LIVING BEYOND THEIR MEANS

If a client is facing divorce, you've probably advised him or her to copy important documents, keep them outside the home, and open bank accounts in his or her name only — legitimate self-protection methods. However, unscrupulous husbands and wives go much further, believing a good defense is an illicit offense. See "Stashing cash" on page 5 for nooks in which crooked divorcing spouses may hide marital assets.

How do forensic accountants find out whether one spouse is concealing cash? The first step is to look at the suspect spouse's lifestyle and compare it to his or her reported income. For instance, what kind of car does the spouse drive and how is it paid for? Where does he or she purchase clothing? What about travel and lodging? If there's a significant gap between reported income and lifestyle, maybe it's filled with borrowed money. Other honest explanations might be a recent inheritance or gift. But if nothing seems to justify an overly affluent lifestyle, there's a good possibility the spouse is funding it with unreported income.

To examine lifestyle expenses, forensic accountants usually request at least five years of business financial statements and personal and business tax returns. They provide insight into the nature of any marital business, and the composition and value of marital assets. In addition, the expert usually examines the opposing party's business and personal records to determine the degree to which funds move back and forth between personal and business accounts.

You may be wondering how accountants treat savings when analyzing the marital lifestyle. By tracing marital savings sources and uses, accountants help counsel determine whether to consider cash savings part of the marital lifestyle for support purposes.

HIDING BUSINESS REVENUES

Dishonest husbands and wives often try to divert business funds to keep them out of their divorcing spouse's hands. It's the forensic accountant's job to discover and stop this fraud. If one spouse owns a business, the expert visits it to check out the way it's run, how often the owner is on the premises, and his or her relationship with employees. All of these details can provide clues as to whether the spouse-owner is receiving unreported income or inflating expenses.

Stashing cash

Exactly what *is* unreported income? It's legal or illegal net cash inflows to an individual or entity that are kept secret for financial or income tax reporting purposes. A divorcing spouse may earn the unreported income in the ordinary course of business, or receive it from his or her company to pay for gifts, travel, rent or tuition.

If the spouse runs a business, he or she might understate income by overstating expenses, for instance recording fictitious payments to nonexistent vendors, then voiding the checks after the divorce. Or, he or she could actually make payments from the business to related parties for services never rendered.

Hiding assets is another popular scheme. There are myriad ways to bury treasure, including:

- Keeping cash in the form of traveler's checks,
- Establishing offshore accounts,
- Layering the ownership of businesses or real estate — for example, multiple layers of shell companies with nominal revenues are used to conceal the identities of their principals and the assets they control,
- Diverting revenues, including skimming cash from a business, and
- Delaying signing long-term business contracts until after the divorce in order to lower the business's apparent value.

Fraudulent techniques are many. The good news is, forensic accountants have successfully dealt with most of them and can help get your client his or her rightful share of marital assets.

Operating expenses. The forensic accountant also scans financial statements and tax returns for suspicious operating expenses and carefully investigates items which appear to be more personal than business related. For instance, if a local supermarket business's records show unusually high costs in the automobile, travel, meals and entertainment categories, the owner could be diverting funds.

Unreported income. When it comes to unreported income, some businesses present more opportunities than others. For example, medical practices derive most of their revenues from insurance carriers, making it unlikely they would fail to report income. But delicatessen businesses receive most of their income in the form of cash, so a dishonest owner could arrange for certain cash receipts to simply not be recorded or deposited.

Cash receipts. In a small business it's likely that one person (often the owner) opens the mail, records the payments and deposits the checks or cash. If this is the case, the expert matches the accounts receivable records to the cash receipts. He or she examines all significant receivable write-offs to see whether they're cover-ups for receipts deposited in an undisclosed, owner-controlled bank account.

Payments' validity and business legitimacy. The forensic accountant performs a comparable analysis of disbursements to test all payments' validity and business legitimacy. The goal is to discover whether any payments represent one spouse's undisclosed income and should be added back to determine the business's income-generating capacity — and its resulting value as a marital asset.

RESTORING THE BALANCE

If a divorcing client suspects his or her spouse is hiding money, retaining a forensic accountant can be a wise investment. For more information about uncovering marital assets during divorce proceedings, please give us a call. We can offer suggestions on how to get your client his or her fair share.

Fraud to watch for:

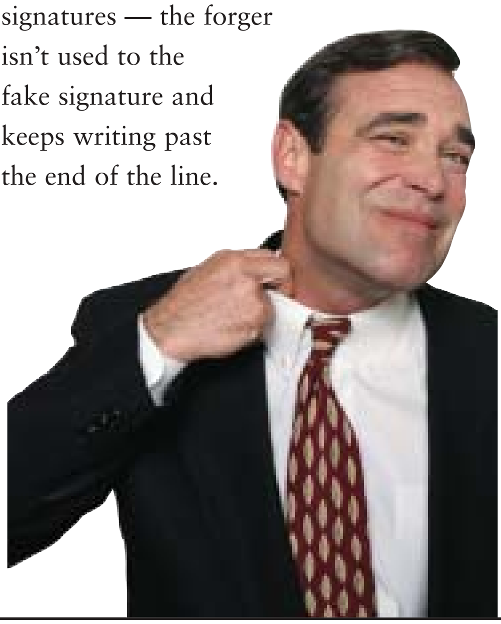
SPOTTING FAKE CHECKS AND CREDIT CARDS

Your retail and other business clients should stay on the alert for phony checks and credit cards, a chronic problem nationwide. The No. 1 preventive measure is simple: Pay attention.

HUGE RED FLAGS

Sometimes it's not difficult to spot forgeries, if employees are at all attentive. Consider these huge red flags:

- Aluminum foil pasted on cards to represent holograms, flattened-out cards with new numbers stamped on them, or changes to the card such as erasures, paint-overs or glued-on signature panels.
- Misspelled information — real check and credit card issuers usually can spell the names of their companies, the months of the year, etc.
- Checks displaying poor print quality, lacking any perforated edges (most real checks have one), and sporting odd-looking signatures — the forger isn't used to the fake signature and keeps writing past the end of the line.



The moral: If a credit card or check looks obviously false, it is.

NORMAL DUE DILIGENCE

Of course, not all false checks and credit cards are so obvious. Retailers should observe customers' behavior. Is the person in a big hurry and buying many expensive or unrelated items? Maybe they're trying to get out the door with as much loot as possible.

When accepting payment, employees must exercise caution if the customer is using a brand-new card. Of course, they should check the customer's signature against the card signature, and watch while the customer signs. Does the person appear hesitant? Maybe he or she can't remember the spelling.

When receiving checks as payment, business personnel should note the number on the check and the date the account was opened, if that information appears. Recently opened accounts are cause for suspicion, because fraudsters frequently apply for new accounts using stolen or false identification.

RIP-OFFS AVOIDED

Phony checks and credit cards are costly to businesses, but your clients can train their staffs to avoid rip-offs. Please contact us if you'd like more information about how to circumvent check and credit card fraudsters. We're happy to help.

Who's reading your clients' e-mail?

Your clients may not know it, but quite a few people besides the intended recipients can read their e-mail messages — even long after they're deleted. The dangers of tampering with e-mail and impersonating an e-mail sender also are real, now that electronic signatures can be considered legally valid. The bottom line: All e-mail users should take steps to safeguard privacy and ensure authenticity.

THWART ENQUIRING EYES

Who can read e-mail? For starters, the Internet service provider staff. If a company has a private e-mail system, the "postmaster" can take a look. Also, not only are passwords available to a variety of e-mail administrators, but hackers specialize in decoding them. And with all e-mails stored digitally and archived indefinitely, enquiring eyes can scan them even after they cease to be breaking news. Fortunately, safeguards such as these exist:

E-mail encryption. One solution is encryption software, such as Pretty Good Privacy® (PGP®), which prevents unauthorized people from reading e-mails. It's fast, unobtrusive and inexpensive.

Encryption works via electronic passwords or "keys." The user has a public and a private key. Nobody without both can read an encrypted e-mail. Users keep their private keys to themselves, but share their public keys with whomever they choose. The keys also assure that the sender is who he or she claims to be — an important safeguard for contracts and other legal documents.

If clients want to send you private messages, for instance, they encrypt them with your public key and you open them with your private key. If they want to prove their identity, they encrypt the messages with their private keys and you use their public keys to open them. Or, they can attain both ends by using your public and their private keys.

Digital certificates. Depending on their authenticity concerns, businesses may also purchase digital certificates from companies such as Nortel and VeriSign. When a company gets an e-mail carrying a certificate, the receiver checks with the provider for authenticity. Certificate prices vary according to how much background checking the provider must do. Both the e-mail sender and receiver must obtain certificates and keep them up to date.

Purging archives, creating audit trails. Because courts can subpoena e-mail messages years after they're written, sometimes necessitating costly recovery and restoration, companies with their own e-mail systems might consider regular archive purges. To guard against tampering with important e-mails, businesses might also want to obtain software that creates an audit trail of all changes.

HEADS UP

Of course, everyone should be careful when using e-mail. But it's easy to forget how vulnerable communications really are, so the safest companies are those that take routine precautions. For more information on beefing up e-mail security and ensuring authenticity, please contact us. We'll be glad to discuss the options available.

Craig L. Greene, CFE, CPA

An internationally recognized public speaker, Craig has lectured on topics involving fraud and its detection to auditors, investigators and attorneys. He is a faculty member of the Association of Certified Fraud Examiners and Institute of Internal Auditors.

Craig works as a consultant and expert witness for major corporations, law firms, law enforcement and governmental agencies on cases involving allegations of fraud and misrepresentation. Craig is frequently quoted in major newspapers and publications throughout the U.S.

McGOVERN & GREENE LLP

Certified Public Accountants & Consultants

Specialists in Fraud Examination and Litigation Services

If a business hasn't yet been a victim of fraud, it's been fortunate. According to the Association of Certified Fraud Examiners, fraud costs businesses in the United States billions of dollars every year. Small businesses are especially vulnerable because they often do not have controls in place to reduce the likelihood of fraud.

This is where McGovern & Greene LLP can help. Our firm specializes in helping corporations, attorneys, lenders, law enforcement and governmental agencies analyze financial records and contracts, identify and prevent fraud, recover and analyze evidence, and provide expert testimony in all of these matters. Our highly-experienced team of professionals includes certified fraud examiners and certified public accountants that are experts in the fields of fraud examination, forensic accounting, computer forensics, damage calculations, business valuations and audit services.

Our professionals can assist you in a wide range of matters, including:

- Fraud Examination
- Financial Investigations
- Forensic Accounting
- Asset Recovery
- Internal Audit Services
- Computer Forensics
- Training & Seminars
- Healthcare Audit
- Business Valuation
- Litigation Services
- Government Contracts
- Economic Damages
- Intellectual Property
- Contract Claims
- Construction Audits
- Electronic Discovery
- Profit Recovery
- Due Diligence

We welcome the opportunity to discuss your needs and answer any questions you might have about our fraud examination and litigation services.

Please contact us at 312.419.1961 or visit us at www.mcgoverngreene.com and let us know how we can be of assistance.

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