Valuation & Litigation Briefing

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Fight fraud with active detection methods

The Association of Certified Fraud Examiners (ACFE) recently released its *Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse*. This biennial report — based on an analysis of 2,690 occupational fraud cases from 125 countries investigated between January 2016 and October 2017 — provides valuable guidance to help businesses, attorneys, and forensic experts prevent, detect and investigate fraud.

A key takeaway is that *active* detection methods (such as surprise audits or data monitoring and analysis) are far more effective than *passive* methods (such as confessions or notification by police) in reducing fraud loss and duration. Unfortunately, many companies fail to use these methods to their full potential.

Active vs. passive detection

The best way to minimize fraud losses and the duration of fraud scams is to implement antifraud controls to actively detect schemes, rather than waiting to receive tips or confessions. The ACFE study found that frauds detected using passive methods tend to last longer and produce larger losses than those detected by such active methods as:

- IT controls,
- Data monitoring and analysis,
- Account reconciliation,
- Internal audit,
- Surprise audits,
- Management review, and
- Document examination.

These active methods of detection can significantly lower fraud durations and losses. For example, frauds detected by IT controls had a median duration of five months and a median loss of $39,000. By comparison, fraud detected through notification by police had a median duration of 24 months and a median loss of $935,000.

Surprise audits and proactive data monitoring and analysis can be especially effective ways to fight fraud. On average, victim-organizations without these antifraud controls in place reported more than double the fraud losses and their frauds lasted more than twice as long as victim-organizations with these controls in place. Yet only 37% of the organizations in the ACFE study had implemented surprise audits or data monitoring and analysis, however.

Close-up on tips

The ACFE categorized tips — the leading fraud detection method — as "potentially active or passive," because they may or may not involve

proactive efforts designed to identify fraud. Organizations that use hotlines for reporting misconduct detected fraud by tips more often (46% of cases) than those without hotlines (30% of cases).

More than half of tips came from employees, but nearly one-third came from outside parties, such as customers and vendors. To ensure that tips are used as an active detection method, an organization should set up a hotline and promote its use among employees, supply chain partners and others. If possible, users should be able to make anonymous reports.

Lessons learned

Here are other key findings from the ACFE's 2018 study:

- Asset misappropriation occurred in 89% of cases. It was the most common but least costly type of occupational fraud, with a median loss of $114,000.
- Financial statement fraud occurred in 10% of cases. It was the least common but most costly type of occupational fraud, with a median loss of $800,000.
- Corruption, such as bribery or conflicts of interest, occurred in 38% of cases. It caused a median loss of $250,000.
- Internal control weaknesses were responsible for nearly half of fraud cases.
- Small businesses with fewer than 100 employees lost almost twice as much per fraud scheme ($200,000 median loss) than larger businesses ($104,000 median loss). Why? In general, small businesses have fewer resources to implement robust antifraud controls, particularly those that involve separation of duties and independent checks.
- Over the past 10 years, referrals of frauds to law enforcement for criminal prosecution have declined by 16%. The top reason is fear of bad publicity.

Red flags of occupational fraud

According to the latest *Report to the Nations* by the Association of Certified Fraud Examiners, these are the top behavioral red flags exhibited by fraud perpetrators:

1. Living beyond one's means (41% of cases),
2. Financial difficulties (29% of cases),
3. Unusually close association with a vendor or customer (20% of cases),
4. Control issues or unwillingness to share duties (15% of cases),
5. Divorce or family problems (14% of cases), and
6. A "wheeler-dealer" attitude (13% of cases).

The perpetrator showed no behavioral signs of fraud in only 15% of the cases. So, training company insiders to identify behavioral red flags can be an effective tool for helping detect occupational fraud. If a client notices an executive or other employee that exhibits suspicious behaviors, contact a forensic accounting expert to investigate further.

Occupational fraud victims that attempt to recover their losses from the perpetrators are rarely made whole. According to the ACFE survey, 53% of victims recovered nothing, 32% made a partial recovery and only 15% fully recovered their losses. The bigger the loss, the less likely they were to make a full recovery. These statistics underscore the importance of taking steps to detect fraud proactively rather than passively.

How to reduce fraud risks

Occupational fraud poses a significant threat to organizations of every type and size. Before fraud strikes, a forensic accounting expert can evaluate a company's controls and reinforce potential weaknesses. ■

D. Allen Hornberger v. Dave Gutelius Excavating, Inc.

Owners dispute buyout provision of shareholders' agreement

A recent case involving a shareholder buyout illustrates the importance of drafting shareholders' agreements with precision. If the parties in the case had more clearly defined business valuation terms in the agreement, they could have possibly avoided litigation altogether.

Digging deeper into valuation specifics

Dave Gutelius Excavating (DGE) is a closely held excavating subcontractor in Pennsylvania. The plaintiff — a former employee and owner of 10 shares of DGE's stock — had entered into a shareholders' agreement that gave the corporation the right to redeem an employee-shareholder's interest upon termination of employment.

The agreement set the buyout price at "adjusted net book value." Under the agreement, the company's CPA would calculate that amount, taking into account the following specific adjustments:

- "No allowance shall be made for the goodwill or trade name of DGE."
- "Accounts payable shall be taken at face amounts less discounts deductible therefrom, and accounts receivable shall be taken at face amount less discounts less a reasonable reserve for bad debts."
- "All real property … and all tangible personal property … shall be taken into account at their fair market value."

After the plaintiff voluntarily left the company in 2011, DGE offered to redeem his stock pursuant to the shareholders' agreement. The company's CPA estimated that DGE's adjusted net book value was $6,436 a share before discounts. Then the CPA applied "conservative" discounts for lack of control (5%) and marketability (30%), arriving at an adjusted net book value of $4,280 a share.

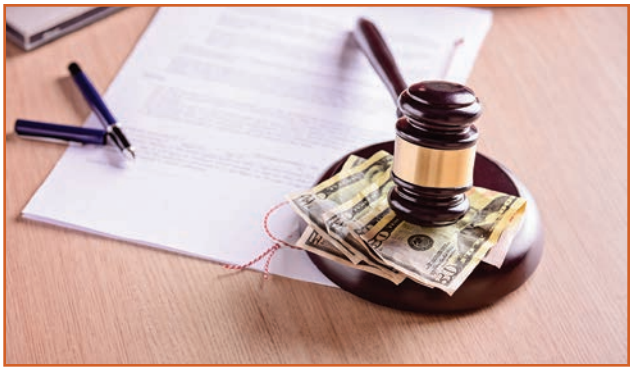
To discount or not to discount?

The plaintiff subsequently filed a lawsuit against DGE, alleging that the CPA's application of discounts for lack of control and marketability violated the shareholders' agreement. Instead, he argued that the value of his 10 shares should be $6,436 each (the undiscounted amount). The plaintiff's CPA expert testified that the three adjustments mandated in the shareholders' agreement were exclusive, and the agreement didn't permit further adjustments.

DGE presented two CPA experts who testified that the determination of adjusted net book value was based on the fair market value standard. They also opined that, when calculating the fair market value of an interest that represents only 1% of a company's outstanding stock, it's customary in the accounting industry to apply discounts for lack of control and marketability.

Defining "adjusted"

The parties essentially disagreed on the meaning of "adjusted" in the term "adjusted net book value." The plaintiff argued that it was defined by, and



therefore limited to, the three adjustments listed in the shareholders' agreement. DGE countered that those adjustments were nonexclusive and that additional adjustments were appropriate, consistent with business valuation practice.

The trial court agreed with DGE, and the Superior Court of Pennsylvania affirmed that decision. The agreement expressly provided that the stock's value would be determined by the company's CPA, which presumed the exercise of professional judgment — including the application of appropriate valuation discounts.

The shareholders' agreement provided that the exercise of professional judgment was subject to the three specific provisions. But the court felt that those provisions couldn't "reasonably be understood to preclude the application of any other adjustments that valuation experts would ordinarily make."

Handle with care

This case highlights the importance of drafting comprehensive buyout provisions that dig into business valuation specifics to clarify the parties' intention. A detailed description of issues related to the value of the business interest — such as permissible valuation methods, assumptions and the appropriate standard of value — can help avoid surprises and disputes down the road. ■

Will your expert pass the *Daubert* test?

A financial expert may be disqualified from testifying if his or her methods aren't reliable and proven. Here's how a *Daubert* challenge works and how to avoid potential pitfalls.

Study the test questions

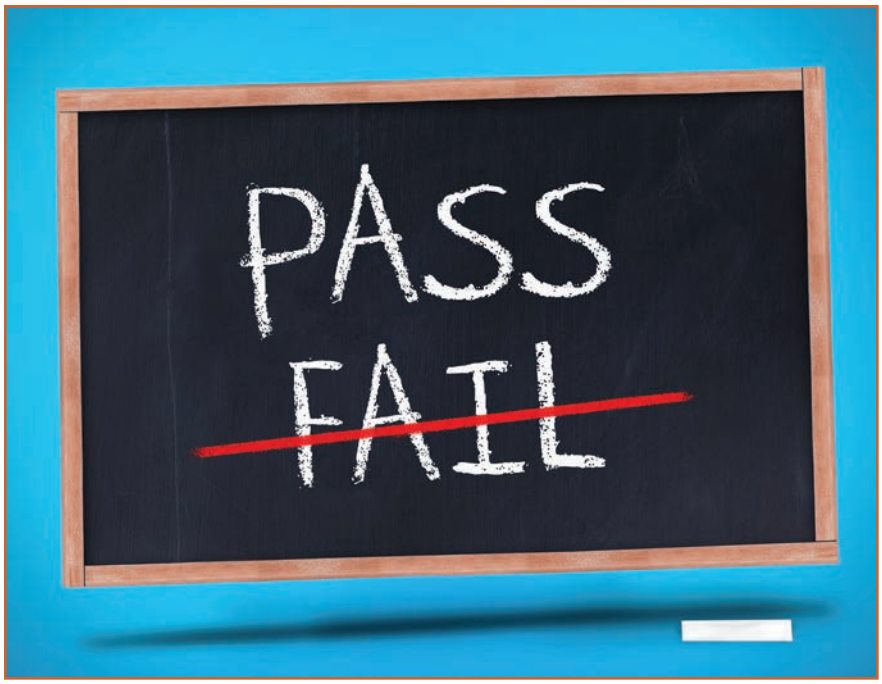
According to Federal Rules of Evidence (FRE) Rule 702, an expert witness may testify if scientific, technical or other specialized knowledge will help a judge or jury make sense of evidence or understand facts. In 1993, a U.S. Supreme Court case, *Daubert v. Merrell Dow Pharmaceuticals Inc.*, affirmed judges' roles as gatekeepers against "junk science."

Rather than addressing the accuracy of an expert's opinion, *Daubert* focuses on the reliability and relevance of an expert's analyses. The *Daubert* test asks the following questions:

- Has the opinion been tested?
- Has it been peer reviewed by other practitioners?
- Has the methodology been published in professional journals?
- What is its known rate of error?
- Has the expert's profession established standards to control its use? If so, has the expert complied with these standards?
- Is it generally accepted among members of the scientific community?

The Supreme Court intended courts to consider these questions with flexibility and consider the method's replicability. For instance, a new method might pass muster if another expert can replicate the expert's analyses — and if the expert can persuade the court that the method is appropriate for the case.

Daubert dealt specifically with medical testimony. So, the legal community initially questioned whether it applied to technical or specialized expert testimony. But in 1999, *Kumho Tire Company v. Carmichael* ended this debate, extending the scope of *Daubert*



beyond scientific testimony to other academic disciplines.

Avoid potential pitfalls

When assessing an expert's chances of withstanding a *Daubert* challenge, it's important to look beyond education, professional designations, industry experience and reputation for qualities that could lead to exclusion during such a challenge. These include mathematical errors, of course.

Further, courts have disqualified financial experts for cherry-picking documents and data sets that supported their side's financial interests. And courts often expect a high level of due diligence concerning the company's operating history and its financial projections. For instance, a disclaimer that the valuation expert accepted a company's projections at face value (without assessing reasonableness) might raise a red flag during a *Daubert* hearing.

In addition, ongoing professional relationships or contingent fees may impair a financial expert's perceived objectivity. Reliable experts maintain independence and avoid acting as advocates for their clients. Obviously, an expert's testimony shouldn't extend beyond his or her area of expertise. Make sure to review relevant *Daubert* case law when challenging opposing experts or defending your expert.

Before motioning for a *Daubert* hearing, realize that the opposition will likely fire back with a similar motion. So first consider your own expert's reliability and the relevance of his or her methodology.

An objective review by a third expert to reveal both experts' mistakes and weaknesses could be helpful. In some cases, your expert's methodology may be sound, but his or her report may require minor improvements. For example, it might be a good idea to ask your expert to explain why he or she rejected alternative methods or excluded specific documents — before you launch an attack on the opposition.

> ***Before motioning for a Daubert hearing, realize that the opposition will likely fire back with a similar motion.***

Learn the rules

A qualified, experienced financial expert can be a tremendous asset to an attorney in cases that deal with accounting malpractice, business valuation, economic damages, fraud and other complex financial matters. In addition to providing professional opinions, these experts can critique an opposing expert's conclusions and help draft deposition and cross-examination questions.

Today, courts have high standards when it comes to the education, experience and credentials of expert witnesses. So, it's critical to understand the guidelines for admitting expert witnesses. ■

Beyond cryptocurrency

Blockchain could revolutionize the legal industry

Blockchain is best known as the digital technology behind bitcoin. But its potential uses in the legal, business and financial worlds go well beyond virtual currencies.

What is blockchain?

In simple terms, blockchain is a distributed, shared ledger that's continuously copied and synchronized to thousands of computers. These so-called "nodes" are part of a public or private network.

The ledger isn't housed on a central server or controlled by any one party. Rather, transactions are added to the ledger only when they're verified through established consensus protocols. Third-party verification makes blockchain highly resistant to errors, tampering or fraud. The technology uses encryption and digital signatures to ensure participants' identities aren't disclosed without permission.

How is blockchain used?

Blockchain's ability to produce indelible, validated records establishes trust without the need for intermediaries to settle or authenticate transactions. So, the technology lends itself to a wide variety of uses in the legal industry. Here are some examples:

Smart contracts. These contracts allow parties to create and execute contracts directly using blockchain, with less involvement by lawyers or other intermediaries. For example, under a simple lease agreement, a business might lease office space through blockchain, paying the deposit and rent in bitcoin or other cryptocurrency. The system automatically generates a receipt, which is held in a virtual contract between the parties. It's impossible for either party to tamper with the lease document without the other party being alerted.

The landlord provides the lessee with a digital entry key, and the funds are released to the landlord. If the landlord fails to provide the key by the specified date, the system automatically processes a refund.

Service of process. In litigation, demonstrating that service of process has been completed or attempted can be a challenge. Now, some companies are using blockchain to address this issue. Process servers in the field use an app to post metadata — such as GPS coordinates, timestamps and device data — to a blockchain, which generates a unique identification code. Lawyers, courts and other interested parties can use the blockchain ID to access service of process data and confirm that information in physical affidavits or other records hasn't been altered.

Other potential uses include:

- Establishing chain of custody or chain of title,
- Authenticating property,
- Verifying signatures on legal documents, and
- Confirming that you're working with the final version of a document.

Stay tuned

Today, blockchain is just a futuristic, high-tech concept. But widespread implementation of blockchain is coming soon — and it's expected to have a major impact on contract law, electronic discovery and other legal matters. ■