Advocate's EDGE

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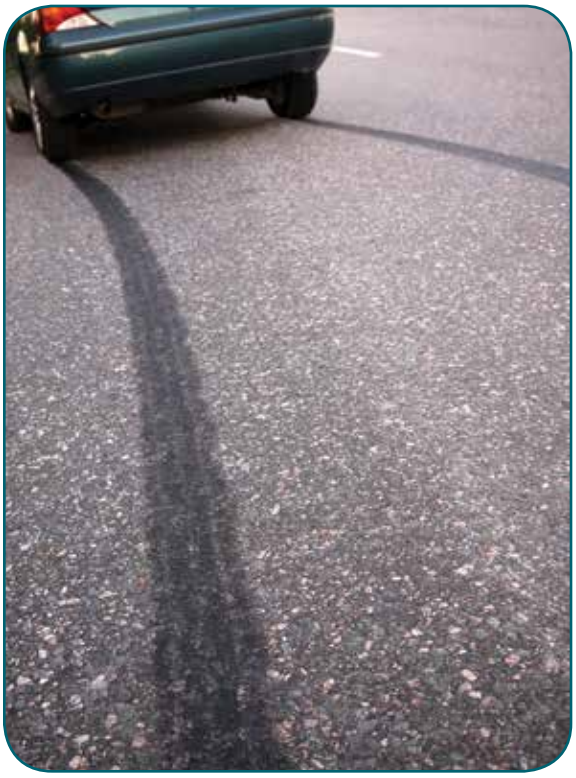
Surprise audits can stop fraud in its tracks

Over the years, the Association of Certified Fraud Examiners (ACFE) has consistently estimated that occupational fraud costs the typical organization 5% of its revenue annually. In its most recent biennial report on occupational fraud, the ACFE found that the median loss caused by fraud was a whopping $145,000.

Clearly, no organization can afford to ignore the risks of employee theft, corruption and financial misstatement. One of the best ways to tackle these risks head-on is to conduct surprise fraud audits.

SURPRISE VS. FINANCIAL

Some of your clients may dismiss the need for surprise audits, mistakenly assuming their annual financial statement audits provide sufficient coverage to detect and deter fraud among their employees. But financial audits were the primary detection method in just 3% of the fraud cases reported in the ACFE study. Although financial audits serve a vital role in corporate governance, the ACFE advises that "they should not be relied upon as organizations' primary anti-fraud mechanism."



By comparison, a surprise audit more closely examines the company's internal controls that are intended to prevent and detect fraud. Here, auditors aim to identify any weaknesses that could make assets vulnerable and to determine whether anyone has already exploited those weaknesses to misappropriate assets. Auditors show up unexpectedly — usually when the owners suspect foul play or randomly as part of the company's antifraud policies — to review cash accounts, bank statements, expense reports, payroll, purchasing, sales and other areas for suspicious activity.

The element of surprise is critical because most fraud perpetrators are constantly on guard. Announcing an upcoming audit gives wrongdoers time to cover their tracks by shredding (or creating false) documents, altering records or financial statements, or hiding evidence.

Fraud perpetrators likely have paid close attention to how previous financial audits were performed — including the order in which the auditor proceeded. So in a surprise audit, the auditor might follow a different process or schedule. For example, instead of beginning audit procedures with cash, the auditor might first scrutinize receivables or vendor invoices. Surprise audits focus particularly on high-risk areas such as inventory, receivables and sales, and auditors typically use technology to conduct sampling and data analysis.

WHO COMMITS FRAUD ON THE JOB?

The Association of Certified Fraud Examiners' (ACFE's) *2014 Report to the Nations on Occupational Fraud and Abuse* looked at nearly 1,500 perpetrators from more than 100 countries. Its findings can prove helpful for targeting fraud detection efforts.

The ACFE found that a majority (52%) of occupational thieves were between 31 and 45 years of age. However, older perpetrators tended to produce larger losses, with those ages 60 and over causing a median loss of $450,000. This supports the finding that greater losses are generally associated with higher levels of authority ($500,000 for executives vs. $75,000 for employees), which typically increases with age and tenure ($220,000 for those with tenure greater than 10 years vs. $51,000 for those with tenure under one year). Higher-level employees generally have greater access to the organization's assets and are better positioned to override controls.

Gender is also relevant. Male perpetrators outnumbered females 2-to-1. The median losses attributed to men were more than double those attributed to women ($185,000 vs. $83,000). This proportion has remained consistent over the ACFE's previous three studies.

BIG BENEFITS

The ACFE's *2014 Report to the Nations on Occupational Fraud and Abuse* demonstrates the primary advantages of surprise audits: reduced duration of schemes and fewer financial losses. Yet, according to the ACFE, only 29% of its survey's U.S. respondents reported performing surprise audits.

The median loss for organizations that conducted surprise audits was $93,000, compared with a median loss of $164,000 for those organizations that didn't — a 43% difference. This discrepancy is no surprise in light of how much longer fraud schemes went undetected in organizations that failed to conduct surprise audits. The median duration in those organizations was 24 months, compared with only 12 months for organizations that performed surprise audits.

Such audits can have a strong deterrent effect as well. While surprise audits, by definition, aren't announced ahead of time, companies should state in their fraud policy that random tests will be conducted to ensure internal controls aren't being circumvented. If this isn't enough to deter would-be thieves or convince current perpetrators to abandon their schemes, simply seeing guilty co-workers get swept up in a surprise audit should do the trick.

ADDITIONAL INVESTIGATION

The mere discovery of red flags for fraud in a surprise audit isn't enough to take significant action, such as firing an employee or calling in law enforcement. As with financial audits, an auditor's finding of suspicious activity in a surprise audit will likely require additional forensic investigation. Depending on the type of scheme, an auditor might conduct interviews with suspects and possible witnesses, scour financial statements and records, and perform in-depth data analysis to get to the bottom of the matter.

What to do when a "good" acquisition goes bad

Even with the best due diligence efforts, a buyer may find that the company it has acquired isn't the company that management thought it was. When post-transaction disputes arise over such issues as purchase price adjustments (PPAs) and alleged seller misrepresentations, financial expertise is essential.

PROTECTIVE PPA PROVISIONS

Typically, acquisitions are negotiated before closing-date financial statements are available. So the parties must rely on previously issued "reference" financials provided by the seller during negotiations. To avoid unpleasant surprises after the transaction closes and the closing-date financials become available, purchase agreements usually provide for PPAs to reconcile any disparities.

> *A buyer might argue that the business isn't as valuable as the seller represented it to be when the parties negotiated the purchase price.*

For example, if the seller's working capital has increased or decreased between the time of the reference financials and the closing date, the purchase price would be adjusted upward or downward on a dollar-for-dollar basis. In some cases, postclosing revelations can affect the selling company's valuation.

To help avoid disputes, a financial expert can develop specific provisions for PPAs — for example, establish a dollar threshold for determining "materiality" and define the accounting

standards and practices to be applied to both the reference and closing-date financials. Other provisions designed to avoid litigation might include the following:

- Specify the party responsible for preparing reference and closing-date financials. Typically, the seller prepares the former and the buyer prepares the latter. Some agreements call for the seller to prepare both, but this can be problematic because the buyer controls the postclosing books.
- Spell out the formula for calculating PPAs. Typically, it's based on working capital, but some agreements use earnings, cash flow, tangible or total net worth, or some other measure.

Experts avoid including valuation reserves, which are susceptible to manipulation, in their working capital calculations. Working capital should be based on *gross* amounts for accounts receivable and inventory. And reserve levels should be locked to preclude any exercise of discretion or judgment.

RESPONDING TO MISREPRESENTATIONS

Sometimes a buyer discovers facts that its seller failed to disclose, and the buyer brings a "benefit

of the bargain" claim against the seller. Essentially, the buyer argues that the business isn't as valuable as the seller represented it to be when the parties negotiated the purchase price. For example, the seller might lose a major government contract shortly before the acquisition and not disclose this fact to the buyer.

In such a case, the buyer might seek damages based on a revaluation of the target. This is where valuation skills are critical. The buyer's expert might testify that the loss of the contract had a material negative impact on the seller's value and calculate damages based on the alleged diminution in value.

The seller's expert might counter that, based on the target's forecasts and other evidence, loss of the contract isn't expected to hurt its future financial performance or market value. Perhaps this type of customer turnover is an ordinary part of the seller's business. Or perhaps the seller was in the process of negotiating new contracts that would replace the lost revenue.

QUESTION OF MATERIALITY

Another important consideration is the materiality of an alleged misrepresentation. The buyer may argue that it would have paid less for the business had it known about the lost contract. But from the seller's perspective, the loss may have had no impact on the price it was willing to accept.

In some cases, the seller's actual performance may be relevant. If subsequent events demonstrate that the seller's postclosing performance was consistent with the buyer's expectations at the time the transaction was negotiated, the seller might argue that the buyer received the benefit of its bargain after all.

CONVINCING CASE

If your client's acquisition turns to litigation, don't head to court alone. A financial expert with experience calculating damages, assessing business value and finding fraud can help you make the most convincing case.

How can predictive coding speed up discovery document searches?

Technology that can streamline the document search process — whether for production or review — enjoys a prominent place in legal discovery. Keyword searching usually leads the way, but predictive coding has been making waves of late. Two recent discovery disputes illustrate how this technology can come into play.

DEFINING TERMS

Predictive coding is what's known as a "learning technology." It combines human input or guidance with computer-driven concept searching to "train" software to recognize relevant documents. Specifically, a human reviews a statistically significant sample of documents and marks the documents as relevant or not. Such determinations are entered into the predictive coding engine, which then uses them to locate similar documents.

Whereas keyword searches associate documents based on specified words or phrases, predictive coding doesn't require the user to identify all potentially relevant keywords upfront. It finds

and classifies documents based on concept similarity, rather than the words they include. After the results are validated (or not), the engine can be retrained for more accurate results and run again on the same set of documents.

COURT'S FIRST RULING

A federal district court considered predictive coding in two discovery disputes that arose in *In re Bridgepoint Education, Inc., Shareholder Derivative Litigation*. This shareholder derivative lawsuit related to Bridgepoint's offer to purchase up to 10.25 million shares of its common stock pursuant to a self-tender offer. Before the case was ultimately dismissed, the court issued several discovery rulings.

One involved the plaintiffs' attempt to expand the scope of discovery from the agreed-upon period of 34 months to 43 months. Among other arguments, the defendants contended that the additional production would increase its review costs by 26%, or roughly $390,000. The plaintiffs countered that the defendants' figure reflected the cost of manual review, rather than the predictive coding system the defendants would employ. According to the plaintiffs, the additional burden to the defendants would total only about $11,279.

The defendants argued that predictive coding doesn't make manual review for relevance elective. Attorney review is still necessary to ensure produced documents are relevant and not privileged, so the cost of manual review can't be ignored. The court ultimately concluded that the substantial burden of producing documents from the expanded period outweighed the benefit.

METHODOLOGY DISPUTED

The plaintiffs also asserted that the documents already produced for the individual defendants should be run through the predictive coding software. Before the plaintiffs had even propounded their discovery requests, the defendants had run a list of unilaterally selected search terms over the individual defendants' e-mails.

The defendants submitted that their choice of review method for the e-mails was reasonable and they shouldn't be required to run already-screened documents through predictive coding. They claimed that doing so was likely to negatively affect the reliability of the coding process. Instead, the defendants offered to run additional search terms using the original linear screening method.

The district court approved the defendants' method for identifying responsive documents by running additional search terms. It directed the parties to meet and confer regarding what terms the plaintiffs would like the defendants to use.

FUTURE IS CLEAR

Predictive coding is bound to become increasingly prevalent in discovery involving electronic evidence. As courts become as familiar with predictive coding as they now are with keyword searching, they may arrive at different cost-benefit conclusions for applying the technology than the court in *In re Bridgepoint Education* did. Attorneys should familiarize themselves with predictive coding processes as soon as possible or at least hire qualified experts with experience using the technology in a discovery context.

Business valuation

Court weighs in on quality and quantity of evidence

When a business's value is in dispute, the dueling parties usually turn to qualified valuation experts. However, sometimes parties assert their own opinions about value. Or they submit expert opinions that are rejected for failure to meet professional standards and reliance on insufficient data.

After the trial court was confronted with a case featuring both of these circumstances, it declined to assign a value. However, in its unpublished opinion (*Hugh v. Hugh*), the Virginia court of appeals found that the lower court had possessed "a relative wealth of information" from which it could have valued the business.

TRIAL COURT PUNTS

The business was a marital asset in a divorce case. The wife had held a 51% interest in the predecessor business, but the husband ran the company. He dissolved that company in June 2011 and reopened under another name. The husband was listed as the 100% owner of the new business. Tax returns showed a massive drop in income from 2010 to 2012, and the husband — who didn't present expert testimony — claimed the company was worth nothing.

The wife's expert received "scant" evidence from the husband. Instead, he reviewed the company's website, tax returns, financial and bank statements, invoice and purchase orders, and depreciation and amortization schedules, as well as depositions of the husband and his CPA. Applying a market approach, the expert valued the business at $1.4 million. He testified that this value was based on "sound foundation and fact and accounting theory." But he acknowledged that, due to the limited data made available by

the husband, it didn't meet the American Institute of Certified Public Accountants' standards.

Citing insufficient evidence, the trial court declined to value the business or subject it to equitable distribution. The wife appealed.

APPELLATE COURT RETURNS TO SENDER

The court of appeals pointed out that "the type or quantity of evidence required to enable a trial court to value a business is not fixed." Although the trial court had "understandable doubts" about the husband's credibility and the professionally limited basis for the wife's expert testimony, it had sufficient information to value the company.

The court of appeals sent the case back. It directed the lower court to value and distribute the company.

COME PREPARED

The greater the amount of discretion a court exercises when valuing a business, the less likely the decision will be fair and accurate. Arm yourself with a qualified valuation expert who can guide the trial court to the right value.

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- Legal and accounting malpractice claims
- Intellectual property analysis
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Arnie & Company has an especially strong depth of experience in the analysis of commercial damages and in conducting forensic investigations. Dennis Arnie is both a Certified Public Accountant and a Certified Fraud Examiner. He has frequently testified as an expert witness in a variety of state and federal courts and various arbitration hearings.

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