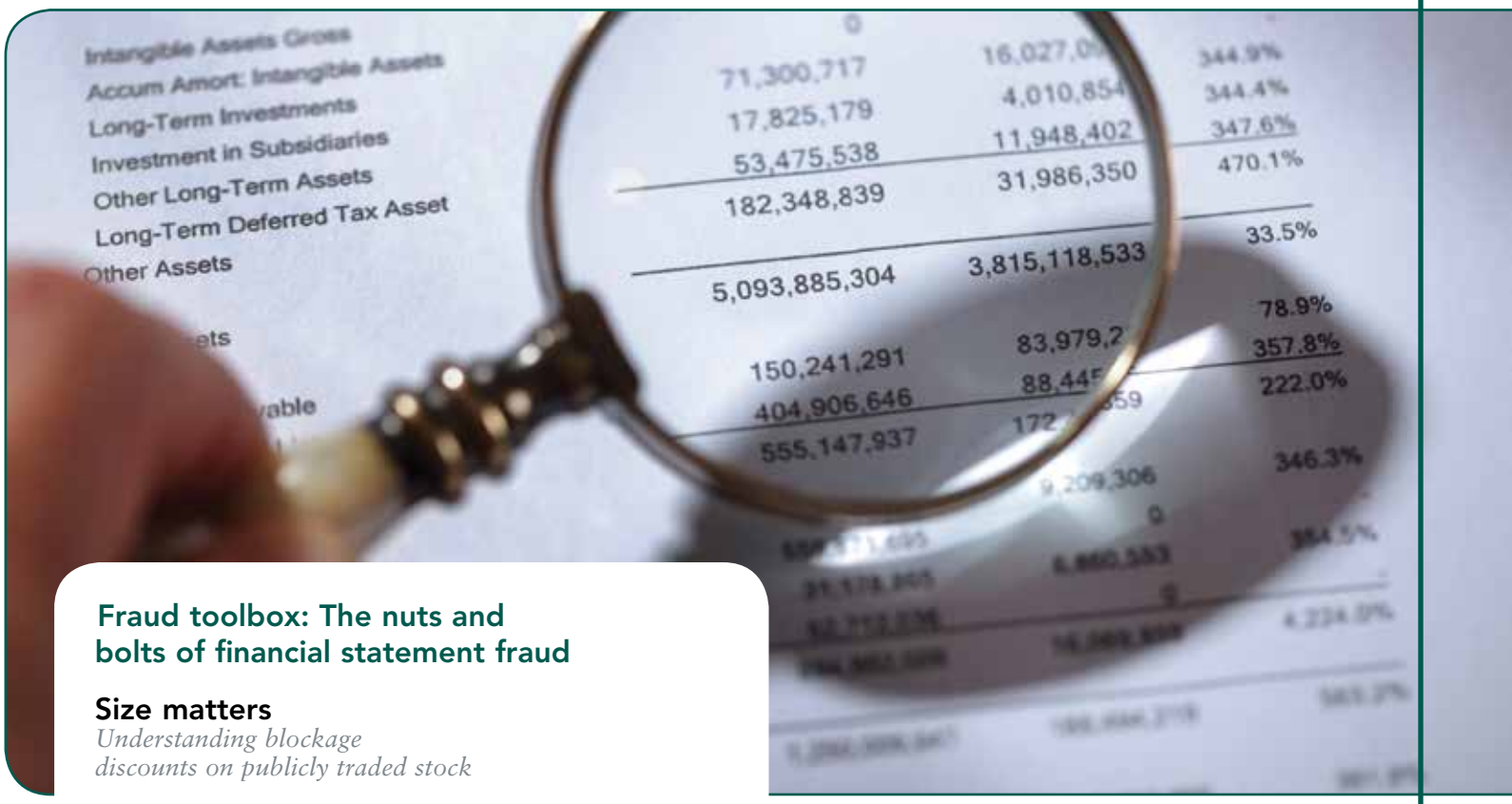
# Advocate's EDGE







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# Fraud toolbox: The nuts and bolts of financial statement fraud

Financial statement schemes continue to rank among the most costly types of occupational fraud for all types of organizations. The costs frequently include more than just the loss of assets — victimized companies also may suffer lost shareholder value, lower employee morale, premature tax liabilities and reputational damage. You can help your clients minimize their risks and losses by understanding how and why financial statement fraud occurs — and how it can be uncovered.

## THE HIGH COST OF FINANCIAL STATEMENT FRAUD

The *Report to the Nations on Occupational Fraud and Abuse* published in 2014 by the Association of Certified Fraud Examiners (ACFE) found that only 9% of the fraud schemes in its survey involved financial statement fraud. Those cases clocked the greatest financial effect, though, with a median loss of $1 million. Moreover, in about 76% of the financial statement schemes, the perpetrator was also engaging in at least one other form of occupational fraud, such as asset misappropriation or corruption.

What makes financial statement fraud especially problematic is that the costs can easily snowball out of control, far beyond what was initially contemplated. For example, when an executive fudges the numbers to make a company appear more profitable, the company will likely incur greater liability for taxes or dividends. It might be necessary to take on debt to make those payments, leading to higher interest costs. Or an acquisition of a healthy company might be pursued to hide the actual underperformance. In the end, more fraud may be necessary to pay for the original fraud.

## COMMON FINANCIAL STATEMENT FRAUD SCHEMES

The ACFE defines financial statement fraud as "a scheme in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports." The methods for committing such fraud aren't just limited to the overstatement or understatement of assets or revenues.

Some of the most prevalent schemes include:

**Concealed liabilities.** Here, liabilities or expenses are recorded improperly. For example, a fraudster might record revenue-based expenses as capital expenditures to increase net income and total assets for the current accounting period or omit significant expenses or liabilities to boost reported profits and working capital.

**Fictitious revenues.** Sales may be artificially reported or inflated. For example, perpetrators may record sales that are subsequently reversed in the next accounting period, or they may create phantom customers.

**Improper asset valuations.** Financial performance may artificially be enhanced by misstating the value of assets — such as failing to write off obsolete inventory — or inflating receivables by booking fictitious sales on account.

**Improper disclosures.** Fraud occurs when perps fail to disclose material information to mislead users of the financial statements. For example, they may fail to report pending litigation, a potentially material contingent liability.

**Timing differences.** Recording revenues in accounting periods different from those of their corresponding expenses can mislead investors.

Revenue recognition is a particularly ripe area for financial statement fraud. Early revenue recognition can be accomplished through several avenues, including 1) keeping books open past the end of the accounting period, 2) delivering products early, 3) recording revenue before full performance of a contract, and 4) backdating sales agreements. In addition, merchandise could be shipped to undisclosed warehouses and recorded as sales. In general, ask questions if a large percentage of revenue is recorded at the end of a period.

## WHO COMMITS FRAUD?

The latest *Report to the Nations on Occupational Fraud and Abuse* compiled demographic information on more than 1,400 fraudsters. The findings indicate that the majority of occupational frauds (78%) were committed by staff at the managerial or employee level. But, not surprisingly, the frauds committed by owners and executives had the highest median loss ($500,000).

Some 7% of the fraudsters were in their first year on the job, and 53% had been with their organizations for more than five years. The longer the fraudster was with the company, the larger the losses typically were. Similarly, 52% of perpetrators were ages 31–45, but older fraudsters tended to cause larger losses. These figures coincide with the finding that greater losses are associated with fraudsters with higher levels of authority — and, in turn, more opportunity to commit costly fraud schemes.

## CAUSES OF FINANCIAL STATEMENT FRAUD

According to the ACFE, individuals who committed financial statement fraud were more likely to be under excessive organizational pressure compared with those who perpetrated corruption or asset misappropriation. Fraudsters may feel pressure to meet earnings expectations or satisfy merger criteria that are required to close a deal. They might commit financial statement fraud in an attempt to make the company look more profitable than it truly is, thereby boosting share prices, fulfilling loan covenants or allowing them to earn bonuses.

## HELP YOUR CLIENTS HELP THEMSELVES

Companies that fall prey to financial statement fraud can find their long-term survival severely threatened. By bringing in qualified forensic accountants, you can help these companies identify red flags, ferret out ongoing schemes and deter future fraudsters.

# Size matters

*Understanding blockage discounts on publicly traded stock*

Discounts for lack of marketability and lack of control are well known to attorneys whose practices commonly call for valuations. A lesser-known type of discount could, however, also lead to discounts that have a significant impact on estate and gift tax planning, as well as divorce cases and a variety of other types of litigation.

## BLOCKAGE DISCOUNTS IN A NUTSHELL

Blockage discounts may be implicated when the value of large blocks of publicly traded stock is at issue. Such blocks might have substantial face value, but it often proves difficult to realize this value in the relevant market.

If a block of shares is large, relative to the number of outstanding shares or the normal trading volume for that company's shares, the shares may not be suitably liquid. In either situation, selling the entire block in a short period of time will likely depress the market price. Conversely, "dribbling out" the block of shares over an extended period makes the seller vulnerable to daily price fluctuations. A "hypothetical willing buyer," therefore, would demand a lower price than the market price.

In recognition of these risks, the American Institute of Certified Public Accountants, the American Society of Appraisers and federal estate tax regulations all allow for blockage discounts in appropriate circumstances. The discount is generally defined as a deduction from the current market price of a stock to reflect the decrease in the per-share value of a block of stock that's so large it couldn't be sold in a reasonable period given normal trading volume.

## BUILDING THE BLOCKAGE DISCOUNT

Not every block of stock is a candidate for a blockage discount. When one is determining whether a discount should be applied, relevant factors can include:

- The size of the block compared with the total outstanding shares,
- The size of the block compared with the stock's normal daily, monthly, quarterly and annual trading volume,
- The size of the block compared with the stock "float" (the amount of stock available for market trading),
- Historic dividends,
- The existence of resale restrictions on the block,
- The volatility of the company's stock price,
- Recent trends in the stock price,
- Projected earnings for the company,
- The company's current economic outlook,

- General economic trends,
- The effects of previous high-volume transactions,
- The stock exchange where the stock trades, and
- Selling costs.

Not every factor will be relevant to every case, and some factors may have more or less weight than others.

Once it's determined that a blockage discount is appropriate, a qualified valuator will calculate the discount amount based on the method of disposition. For example, a large block of stock could be sold through a secondary public offering, a full or partial stock redemption with the subject company, or a private placement transaction. It could also be disposed of by dribbling out the shares in small lots in public markets over a period of time. The ultimate discount should account for the difference between the hypothetical sales price (or, in the case of dribble-out sales, the sales prices) and the actual trading price on the valuation date.

### COVER YOUR BASES

The specific facts and circumstances surrounding a block of stock — including company, industry and economic factors — will determine whether a blockage discount applies. If so, the best approach is to apply multiple calculation methods to reconcile and reach an overall discount.

# When divorce cases get sticky

*Make sure business owners base their pay on current market rates*

Divorce can be messy, especially when it involves a controlling interest in a closely held business that has the power to set compensation levels. A professional valuator can help evaluate owners' compensation, providing objective data sources that enable you to arrive at a fair outcome for both parties.

### REPLACEMENT COMPENSATION

How much compensation a divorcing business owner receives can dramatically affect his or her property settlement and support payments. For example, Pat owns a construction company and decides to claim an above-market salary to reduce the business's value and, in turn, the amount of the property settlement. Or, in a different scenario, Pat claims an artificially low salary to reduce alimony and child support obligations.

Ideally, replacement compensation for an owner of a closely held business like Pat's is the compensation he or she would be paid in an arm's-length transaction for the services performed. A valuation expert would, therefore, determine the amount that a hypothetical employee who doesn't own part of the business would be paid to perform those same services. Replacement compensation needs to reflect the services rendered and shouldn't be confused with distributions of the business's earnings.

### WEIGHING THE FACTORS

Valuators weigh a variety of factors when determining replacement compensation for a specific owner. Experts often look at an owner's role in the business. A law firm, for example, may employ numerous "partners," but they don't all fill the same roles. Some are rainmakers, while others fight in the litigation trenches or manage the firm's operations. A valuator considers the experience and qualifications *necessary* to fill the partner's specific job, as opposed to simply the qualifications the partner happens to possess.

## UNDERSTANDING THE COMPARABLE POSITIONS

The compensation received by similarly situated employees at similar companies is often useful. Valuators gather such data from a growing collection of sources, including the Bureau of Labor Statistics, the Medical Group Management Association, the Economic Research Institute and professional associations.

Also look inside the company to compare the specific owner's compensation with salaries paid to nonowner employees. If the business consistently pays below-market rates for other employees, it may be harder to justify an above-market rate for the company's owner.

## UNDERSTANDING THE COMPANY'S CHARACTERISTICS

The business's size, complexities, industry, competitive position, financial condition and history all affect replacement compensation levels. Companies with a long record of high revenues from loyal customers generally can afford to pay high compensation. But smaller companies might pay a significant salary premium to woo those same employees.

Moreover, a technology-based firm located in an urban area will probably have greater access to comparable employees than a similar company in a rural area. The cost of living is relevant, too. An owner in New York City requires more compensation than an owner in Detroit to maintain a similar standard of living.

## DETERMINING BASIC VARIABLES

When determining replacement compensation for a partner in a professional practice, valuators consider some basic variables. These include the type of professional services offered (such as accounting, law or financial planning) or medical practice specialty, and the duration of the partner's practice.

Other factors might be the age and health of the partner, hours worked and general productivity, the practice's market, and the number of locations in which the practice operates. Management or administrative responsibilities handled by the partner will also play a role in determining replacement compensation.

## FINDING HOLES IN THE TESTIMONY

Bringing on a professional valuator can help you avoid complications when it comes to assessing owners' compensation. Remember that not all testimony carries equal authority. So consider issues that will affect the credibility of the valuator's testimony on replacement compensation, including the source of data used to form the expert's opinion.

## THE BOTTOM LINE

It's also critical to consider if the data has a regional or national scope, the sampling sizes, and if the data provides means (average values) or medians (middle values). Finally, consider whether the data includes owners whose compensation is made up of both straight compensation and a stake in the business's profits.

# Court sheds light on ESI subpoenas for third parties

A California appellate court, relying on federal case law, recently issued a ruling that provides some useful reminders on third parties' obligations to provide electronically stored information (ESI) when subpoenaed. The court's findings resulted in a reluctant third party incurring more than $11,000 for the plaintiffs' attorneys' fees and costs.

## PLAINTIFFS SEEK ESI

The plaintiffs were former students who were suing a culinary school for fraud, alleging the school had deceived the students (by playing up employment and income possibilities) to get their tuition dollars. SLM Corporation, also known as Sallie Mae, serviced student loans obtained by some of the students to finance their schooling. The students issued Sallie Mae a subpoena seeking production of their loan files.

After Sallie Mae informed the plaintiffs that obtaining the documents would cost about $60,000 under the state statute authorizing reasonable charges, they sought ESI consisting of specific data fields on student loans for 786 plaintiffs. They requested that the information be produced "on digital data disk(s) in a reasonably usable form, in a format that is electronically searchable and sortable." The second subpoena also requested a cost estimate.

Sallie Mae filed a motion to quash the subpoena. The trial court denied the motion and granted the plaintiffs' motion for attorneys' fees and costs.

## COURT TURNS TO FEDERAL RULINGS

Under California law, a trial court can award attorneys' fees and costs incurred in making or opposing a motion to quash if the motion was made or opposed in bad faith or without substantial justification. In appealing the award, Sallie Mae argued that its motion was substantially justified because it was required to undertake extensive computer programming to create a spreadsheet that didn't already exist.

In light of the slim state law on discovery of ESI — and because of the similarity of California and federal discovery law — the appellate court looked to federal precedent. It noted that federal courts have held that a subpoenaed person can't object to the production of ESI on the grounds that it can be produced in paper form if the requesting party has specified production in an electronic format.

The court concluded that the fact that the requested information existed in paper form didn't excuse Sallie Mae's obligation to produce it in an electronic format and in a reasonably usable form. It also dismissed the notion that a nonparty can avoid complying with a subpoena seeking ESI simply because it must create new code to format and extract the information from its existing systems.

## FEES AND COSTS AWARD UPHELD

The appellate court ultimately found that Sallie Mae's objection to the second subpoena was without merit. Sallie Mae lacked substantial justification for refusing to comply with the second subpoena, and the trial court's award wasn't an abuse of discretion.

# The experience you need. The service you want.

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- Fraud investigations
- Lost profit analysis
- Securities claims
- Shareholder derivative actions
- Purchase/Sales agreement warranty claims
- Legal and accounting malpractice claims
- Intellectual property analysis
- Other economic damage claims

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.

Thanks to the firm's commitment to delivering outstanding service, Arnie & Company has become a trusted advisor to many leading law firms and businesses in the Houston, Dallas, and Austin areas. Our clients include numerous Fortune 500 companies in various industries, as well as significant privately held companies and individuals.

We welcome the opportunity to put our experience and advanced knowledge of commercial damage analysis and forensic accounting to work for you and your clients. Please call us at 713-840-1634 and let us know how we can be of assistance.

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