Advocate's EDGE

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New report highlights the importance of antifraud controls

As the economy only slowly recovers from a serious recession, your clients are probably concerned about their bottom lines. They may fail, however, to recognize one of the most significant threats to profitability: employee fraud. The recently released *Report to the Nations on Occupational Fraud and Abuse* from the Association of Certified Fraud Examiners (ACFE) reinforces the severity of the threat.

GLOBAL PERSPECTIVE

Since 1996, the ACFE has issued biannual reports that analyze the costs, methodologies and perpetrators of fraud within U.S. organizations. The latest report, which compiles more than 1,800 cases of occupational fraud reported by the CFEs who investigated them, is the first to include data from around the globe.

According to the ACFE, while some regional differences exist, for the most part employee fraud seems to operate similarly whether it occurs in Europe, Asia, South America or the United States. The report estimates that the average organization loses 5% of its revenues to fraud annually. But it also suggests that organizations can minimize fraud risk by implementing effective antifraud controls.

Survey respondents were asked about the types of antifraud controls in place in the victim organizations when fraud was perpetrated. More than three-quarters of the organizations hired external auditors to audit their financial statements. Two-thirds employed dedicated internal fraud or fraud examination departments, and almost 60% had independent audits of their internal controls over financial reporting. Fewer than half of the victims had hotlines or similar fraud reporting mechanisms.

MAKING THE CONNECTION

Smaller companies typically devote fewer resources to antifraud controls and also report a higher incidence of fraud. To examine the correlation between controls and fraud rates, the ACFE compared the existence of various controls at companies with fewer than 100 employees with those at larger organizations.

Its findings confirmed a striking gap between the controls in place at small and larger organizations. The smaller organizations often lacked even less expensive controls such as:

- Management review of controls, processes, accounts or transactions,
- Formal codes of conduct,
- Antifraud policies, and
- A confidential fraud hotline.

Of course, having antifraud controls didn't prevent the organizations in the survey from becoming victims. Controls did, however, seem to affect the amount they lost.

The report compares the median loss experienced by organizations with specific controls against the median loss for organizations without those controls at the time of the fraud. Companies with hotlines saw the greatest associated reduction in median loss — a 59% difference.

WHAT WORKS

Over the years, ACFE's reports have shown that most occupational thefts are detected as a result of tips. The 2010 report indicates that victim organizations with fraud hotlines not only suffered much smaller losses than those without hotlines, but also detected fraud incidents seven months sooner.

Employee support programs, surprise audits and fraud training for all levels of staff were also linked with median loss reductions of more than 50%. (For more on the effectiveness of surprise audits, see "Keeping potential thieves on their toes" at right.) The most common control — external financial statement audits — seemed to have one of the smallest effects, reducing median losses by 25%.

CUSTOMIZED CONTROLS

As with previous ACFE reports, the newest one emphasizes that companies need effective antifraud controls if they want to contain losses. A qualified expert can work with you and your clients to develop and implement the controls most appropriate to their size, industry, budget and specific risks. ◗

KEEPING POTENTIAL THIEVES ON THEIR TOES

According to the 2010 *Report to the Nations on Occupational Fraud and Abuse*, one of the most effective antifraud tools — and also one of the least used — is the surprise audit. Less than 30% of surveyed organizations used them, yet surprise audits have been credited with reducing fraud losses by more than 50%.

Unscheduled audits are effective, not so much because they can catch perpetrators red-handed, but because they contribute to an antifraud culture. If potential thieves know that an audit could happen at any time and that management is committed to rooting out and punishing fraud, they're less likely to risk it. To ensure these audits have the desired effect, it's critical to communicate the possibility to employees — and to actually carry through with them when no one in the organization expects it.

Authentication issues: Who creates ESI?

Like all evidence, electronically stored information (ESI) must be authenticated before a court will admit it, and one of the threshold steps is establishing the owner/creator of the proposed evidence. Most digital documents are created by a single individual, but documents are often passed around to others who can make changes and store them on their own devices.

This cycle could be repeated multiple times, making it difficult to pin down authorship. But the recent work of an industry group could help attorneys determine whether a piece of ESI will be acceptable in court.

CHALLENGING DATA

The Sedona Conference® Working Group Series, an influential think tank of jurists, attorneys, experts and consultants, identified several challenges to determining the creator of ESI in its report *Commentary on ESI Evidence & Admissibility*. They include:

Metadata. The Sedona Conference describes metadata as "data about data," such as authorship information in Microsoft Word documents. Unfortunately, the "Author" field in Word doesn't automatically change after the original file creation. Therefore, it doesn't reflect the authors of modifications. The field also

can be manually changed by subsequent users, further undermining the field's usefulness in establishing authorship.

Metadata can be subject to hearsay objections, too. The success of a hearsay challenge may depend on whether it opposes system metadata (created by a computer without user input) or application metadata (generated as a result of user input). The hearsay rule generally requires a "person" or "declarant" to make a statement, meaning system metadata doesn't constitute hearsay. Application metadata, on the other hand, might constitute hearsay.

Shared collaborative environments. These enable a number of users to access ESI. They include multiauthor company blogs and wikis that allow the creation and editing of Web pages. Some systems track and store information on users with access and who have modified documents, but many don't. And without knowing for certain whether a single person with access authored a document, or whether several parties contributed, how can such evidence be authenticated?

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System-created documents. A party may wish to present ESI that has been generated by a system, rather than an individual, such as a log of visited Web sites. The problem is that the application developer might be the only person with knowledge of how the information is generated and could be unknown or unavailable.

Open source software, for which the underlying source code is available to all (as opposed to most commercial software's protected code), throws another wrench in the works. Evidence about how and where ESI was created may be available, but it can require time-intensive and costly work by experts to ferret it out.

Aggregated documents. Some computer programs aggregate information from multiple sources. They might summarize the information and present it in a uniform manner, or further process the data before presenting it. A corporate intranet for employees, for example, could contain information created by employees alongside system-generated data and information from an external Web site. It may be difficult to determine the author of every underlying piece of aggregated ESI.

THE BALL'S IN … COURT

Cases addressing these complicated issues are percolating through the courts. But few precedential rulings have emerged. Perhaps, as the Sedona Conference suggests, they'll be resolved by admitting the evidence and allowing juries to determine its weight in light of the issues. In the meantime, attorneys need to look out for ESI with questionable authorship because it could help — or hurt — their position in court.

Rule 26 amendments

Extending greater work product protections

The first amendments since 1993 to the expert provisions of Federal Rules of Civil Procedure Rule 26 are scheduled to take effect Dec. 1, 2010. They were proposed largely in reaction to certain practices that resulted from the 1993 amendments. The new amendments, among other things, extend work product protections to the discovery of testifying experts' draft reports (with three critical exceptions).

PRACTICAL PROBLEMS

According to the report of the Judicial Conference of the United States, new amendments are necessary because earlier amendments to Rule 26 were interpreted to:

1. Allow discovery of all communications between attorneys and expert witnesses,
2. Allow discovery of all draft expert reports, and
3. Require reports from all witnesses offering expert testimony.

The Judicial Conference found that "significant practical problems" have emerged over the years as this interpretation has been applied. For example, attorneys and experts have taken "elaborate steps" to attempt to discover the opposing party's drafts and communications while avoiding generating any discoverable record themselves.

The report specifically calls out the "artificial and wasteful discovery-avoidance practice" of attorneys retaining two experts. In such situations, one consulting expert performs the work and develops the opinions, and the other expert provides the testimony — thereby preventing the creation of a discoverable record.

The report also cites attorneys who prohibit their experts from taking notes, making records of preliminary analyses or opinions, or producing draft reports. Such attorneys intend that the only record will be a single final report.

NEGATIVE CONSEQUENCES

The Judicial Conference found that these discovery-suppressing practices have several negative consequences. For example, they:

- Increase the costs and burdens of discovery,
- Impede the efficient and proper use of experts by both sides,
- Detract from cross-examination into the merits of experts' opinions,
- Make some qualified individuals unwilling to serve as experts, and
- Reduce the quality of the experts' work.

What's more, they needlessly prolong depositions. Attorneys in depositions of the opposing party's experts spend time trying to unearth information about the development of the witnesses' opinions "in an often futile effort to show that the expert's

opinions were shaped by the lawyer retaining the expert's services."

Finally, the report advises on the most successful means of discrediting an expert's opinions — cross-examining the substance of the opinions and presenting evidence establishing why the opinions are incorrect or flawed.

NEW WORK PRODUCT PROTECTIONS AND MORE

The new amendments address the problems articulated by the Judicial Conference. They call for discovery into expert draft reports and many communications between an expert and a retaining attorney to be subject to work product protections.

The amendments carve out three exceptions, though. Rule 26(b)(4)(C) provides that discovery is allowed for communications that 1) relate to compensation for the expert's study or testimony, 2) identify facts or data that the attorney provided and the expert considered in forming the opinions to be expressed, or 3) identify assumptions that the attorney provided and the expert relied on in forming the opinions to be expressed.

The Judicial Conference report contends that establishing work product protection for draft reports and some types of attorney-expert communications won't interfere with effective discovery or examination at trial. And, in some cases, an opposing party may be able to establish need and hardship to overcome work product protection.

The amendments also address the disclosure of testimony by experts who aren't required to provide a written report. This includes treating physicians and government accident investigators who haven't been retained to provide expert testimony. Under Rule 26(a)(2)(C), an attorney relying on the testimony of such a witness must disclose the subject matter of the testimony and summarize the facts and opinions on which the expert is expected to testify.

GOING FORWARD

The U.S. Supreme Court has approved the Rule 26 amendments, and, absent congressional intervention (which isn't expected), they'll take effect as planned Dec. 1. Attorneys are likely to need fewer consulting experts, and the protection extended to draft reports may allow experts to revise their drafts more thoroughly before producing their final reports.

Putting a value on human capital

Your clients may not immediately think of employees as assets with a financial value, but human capital is a quantifiable — and critical — part of a business's worth. Companies may need a professional valuator to quantify human capital for a variety of reasons, including litigation.

RHYME AND REASON

A trained and assembled workforce is a component of what is commonly referred to as "human capital intangible assets." The reason for a valuation engagement may determine the valuator's focus and approach.

For example, although human capital isn't treated as a separate asset for the purpose of accounting for business combinations, a trained and assembled workforce may be of great value to prospective business buyers. An assembled workforce isn't recognized as a separate asset when preparing fairness opinions either, but its value may be a factor in determining a transaction's fairness.

The valuation of human capital is also sometimes necessary in a litigation setting — for example, to calculate damages an employee has caused by breaching an employment or noncompete agreement. A manager, for example, might leave a

company to start a competing business and recruit several key employees from her former employer. In this situation, a valuator must determine the cost of such a breach for the company that has lost vital staff members.

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COUNTING COST

When quantifying the value of a workforce, valuators follow one or more of three approaches. With the *market* approach, they examine actual market transactions involving comparable companies. But the usefulness of this approach may be limited because data can be hard to come by. With the *income* approach, they measure the present value of future economic benefits — a method that may be suitable for professional firms but is less appropriate for capital-intensive businesses.

The most commonly used approach is the *cost* method. It calculates the recruiting, hiring and training costs associated with the subject company's workforce and estimates the investment that would be required to duplicate it.

In applying the cost approach, valuators may estimate the "reproduction cost," or the cost of creating an exact duplicate of the existing workforce. Or, they may measure the "replacement cost," which is the cost of creating a workforce capable of matching the existing workforce's output.

Replacement cost may hypothesize a workforce that looks different from the current one — for example, a smaller number of employees with superior skills. The valuator then makes adjustments to reflect differences in labor costs and other factors.

When using the cost approach, valuators carefully consider characteristics of the existing workforce that affect value. For example, if the current workforce includes many highly compensated, long-time employees, it may be appropriate to reduce its value to reflect the possibility of re-creating the workforce with younger, lower-paid employees.

QUANTIFYING "PRICELESS"

Whether you hire a valuator to appraise human capital for litigation, a merger or another purpose, ensure your expert has experience with this type of engagement. Many companies consider their workforce "priceless," and valuators have the tricky task of putting numbers on employees' heads.