JANUARY/FEBRUARY 2022

LITIGATION SUPPORT

3 fraud prevention tips for small businesses

Fraud prevention efforts reduce opportunities for employees to steal assets from their employers and for managers to intentionally misstate their companies' financial results. Preventive measures don't necessarily need to be expensive to be effective. Here are some cost-effective ways small business owners can help reduce fraud risks.

1. Adopt a formal code of ethics

For workers to behave honestly, honest behavior must be *labeled* by a clearly defined code of ethics and *modeled* by owners and executives. The HR department typically is responsible for drafting a code of ethics. It spells out what behaviors are acceptable (and unacceptable).

In addition to setting expectations for ethical behaviors and helping to create a positive work environment, the code should describe consequences for noncompliance. Perceived accountability and fear of punishment can serve as powerful deterrents against unethical behaviors. Requiring employees to sign the code annually reinforces their understanding of the code and reminds them that the code is a management priority.

Likewise, the most effective way of promoting compliance with the code is by example. Employees are likely to develop the same attitudes about what's right and wrong — and about following internal controls — as those shown by top management.

It's also important to empower employees to help update the code of ethics and report suspected violations, confidentially and without fear of retribution. For example, a whistleblower hotline open to employees, vendors, customers and other stakeholders can be an effective way to share concerns with ethics officers, internal auditors or other trusted individuals.

2. Hire and promote ethical workers

Another way HR can help prevent fraud is by recruiting and promoting honest workers, especially for positions of trust. Proactive practices may include:

- Checking job candidates' education, employment history and personal references,
- Conducting psychological tests and formal background checks on individuals being considered for employment or promotion to a position of trust,
- Evaluating as part of performance reviews how employees contribute to creating a positive work environment in line with the company's code of conduct, and
- Routinely educating employees about ethical expectations, common fraud scams and reporting mechanisms.

New employees should be trained when they're hired about the company's code of conduct. Existing

employees should receive refresher antifraud training periodically thereafter. Such training should be specific to an employee's level within the organization, geographic location and assigned responsibilities.

3. Monitor employees

Management oversight — that is, having supervisors review their subordinates' work — is a simple way to prevent fraud. Unfortunately, limited staff and excessive trust in long-term employees can cause small businesses to overlook the importance of these preventive measures.

Cash is the target in 80% of fraud scams. Management can monitor cash receipts and disbursements for anomalies by reconciling the amount of cash reported in the company's accounting records to cash balances reported on the bank statement.

It's also important to pay attention to workers' personal spending habits. Most perpetrators don't hoard the ill-gotten proceeds. Instead, they almost always use stolen money to support expensive habits. Investigating any sudden lifestyle changes can help managers detect fraud schemes early and mitigate financial losses.

Uncommon sense

These preventive measures correlate with significant reductions in fraud losses and durations of fraud scams. Yet fewer than half of small businesses have implemented them, according to *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse*. A forensic accounting specialist can help small businesses avoid becoming another statistic in the war against white collar crime. ■

To discount or not to discount?

Court rules no DLOM for 100% interest in dental practice

The application of valuation discounts can be a major source of contention in a legal action. Brightline rules seldom apply. The Indiana Court of Appeals recently upheld a lower court's rejection of a discount for lack of marketability (DLOM) on a controlling interest in a dental practice in a divorce action. Here are the details.

Dueling experts

The husband was a successful dentist who owned six offices that together generated significant revenue and profits. The wife's expert valued four of the offices at $2.7 million. The two remaining offices were preparing to open for business, so she valued them based on assets that had been purchased, arriving at a total value of about $3 million for the entire practice.

The husband's expert estimated that the combined value of the four existing practices was about $2.8 million. He assigned no value to the two offices that hadn't yet opened. Then he applied a 45% DLOM to reach a value of $1.56 million on a controlling, nonmarketable basis.

> Normally, a DLOM is applied to reflect the challenge of selling an illiquid asset that isn't traded on a public exchange.

Trial court's rejection

Normally, a DLOM is applied to reflect the challenge of selling an illiquid asset that isn't traded on a public exchange. It also may be appropriate when a sale would be subject to legal, regulatory or contractual restrictions. In this case, the lower court

Discounts OK in mandatory buyout of minority interest

The Missouri Supreme Court has ruled that certain discounts were appropriate when valuing a minority owner's shares in a family business following a shareholder oppression lawsuit. The court cautioned, though, that such discounts apply only in narrow circumstances.

The plaintiff, who had been ousted as president of the company, argued that discounts for marketability and control are inappropriate when a minority owner is forced to sell back his or her shares to an oppressive majority shareholder. The court agreed that these discounts would have "limited application" in the case of a court-ordered sale to a majority shareholder — but, on the particular facts at issue, they were appropriate.

The jury had already awarded the plaintiff the benefit of an increase in the value of stock for a period of years following her termination. Moreover, the plaintiff's expert testified that her damages should largely be composed of the compensation she would have received for a period of four years following her termination.

According to the trial court, a fair value analysis necessarily includes some anticipated future return on capital. The discounts, therefore, were primarily required because the jury had already awarded the plaintiff a return on capital for several years after her termination based on her own expert's testimony at trial. Without the discounts, the plaintiff would receive a double recovery.

The state supreme court emphasized the "unique facts" of the case in upholding the lower court. Under these circumstances, the balance struck by the application of the discounts didn't "shock the sense of justice."

noted several admissions by the husband's expert that undermined his application of the DLOM. For example, the expert conceded that using a discount greater than 35% would draw IRS attention. He also said that a controlling interest may be easier to sell. And his report stated that "dental practices are easily tradeable as they have a ready market of purchasers (new dentists) graduating each year."

Nonetheless, the expert found the discount appropriate because 65% of the practice's revenues were Medicaid-based. The trial court found the following "deficiencies" in the premises underlying his DLOM:

- The husband didn't intend to sell the practice or any part of it,
- The expert based his assumption that 65% of revenues were Medicaid-based on the husband's undocumented statements, and
- If 65% of the patients were on Medicaid and Medicaid procedures are less profitable than private pay, the conclusion that the Medicaid patients account for 65% of revenues was "illogical."

Because the main difference between the experts' values was due to the DLOM, the trial court determined that the valuation provided by the wife's

expert was more credible and accurate. It rejected the opinion set forth by the husband's expert.

Appellate court steps in

The husband appealed, arguing that the trial court erred by failing to apply a DLOM to the operational offices. However, he didn't dispute the "deficiencies in the premises" underlying his expert's application of a DLOM. Rather, he contended that the court shouldn't have adopted the testimony of the wife's expert over his expert's testimony.

The Indiana Court of Appeals disagreed, pointing out that the two experts' combined valuations of the four offices before the discount was applied were close. The husband's expert, in fact, produced a *higher* value than the wife's expert did for the operating locations. The appellate court concluded that the trial court wasn't required to apply a DLOM and didn't err in valuing the practice.

Ongoing issue

Arguments over the application of DLOMs when valuing controlling interests in private business are nothing new. But substantial discounts may raise a red flag in court. Valuation experts always must be prepared to back up their values with solid supporting evidence. ■

How valuation experts adjust their analyses for fraud

Every business — large or small — faces fraud risks that must be factored into its value. Business valuation professionals understand these risks and know which industries and situations present increased fraud risks.

Over time, fraud can impair the value of a business. In addition to stealing assets, employee theft may harm a company's reputation and lower employee morale and productivity. A company's owners can also manipulate financial records to artificially increase (or decrease) the value of the business, depending on which serves their financial interests.

Assessing risks

Value is a function of risk and return, and one critical risk factor businesses face is fraud. A fraud risk assessment starts with a company's internal controls. When interviewing management, experts ask about the company's policies and procedures to protect assets, improve operating efficiency and ensure reliable financial statements.

A business's first line of defense against fraud is strong internal controls. Examples of internal controls that may help deter fraud are physical and digital controls, fraud training programs, job rotation and duplication policies, background checks, and whistleblower hotlines.

Internal controls can be intentionally circumvented and thus become less effective if managers override policies and procedures or become lax in supervising subordinates. These loopholes undermine a company's efforts to detect and prevent fraud. The risk of fraud can be reduced if the company's financial statements are audited by an outside accounting firm — or if the company's internal audit department conducts physical inventory counts or surprise audits of certain high-risk accounts during the year.

Identifying high-risk assignments

Some businesses are more vulnerable to fraud than others. Companies that have weak controls or operate in high-risk industries may warrant a higher discount rate when discounting future earnings or adjustments to pricing multiples derived from comparable stocks or transactions.

Industries that reported the most fraud cases in the Association of Certified Fraud Examiners' biennial *Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse* include:

- Banking and financial services,
- Government and public administration,
- Manufacturing, and
- Health care.

In addition, some types of engagements — such as shareholder disputes and divorces — can motivate owners who control their companies' books and records to hide assets and downplay income. Experts are particularly mindful of fraud risks when valuing a business for these purposes.

Adjusting for fraud risks

Business valuation experts rely on financial statements to estimate value. If financial statements contain fraud, a valuation will be inaccurate unless it's properly adjusted.

When business valuation professionals analyze financial statements, they might unearth red flags of fraud. For example, an expert may notice a disconnect between revenue growth and changes in key assets (such as receivables or inventory) or sudden changes in gross margin [(revenue – cost of sales) ÷ revenue].

So, what happens if the valuation professional suspects fraud, based on preliminary assessments of the company's internal controls, industry and financial statements? Some business valuation professionals are cross-trained in both valuation and forensic accounting. Others work at large firms that provide both types of services.

When these experts suspect fraud, they typically ask the client to expand the scope of the engagement to include forensic accounting services. This usually requires a revised engagement letter or an addendum to the existing contract.

Sole practitioners without forensic accounting training generally refer clients to separate forensic accounting specialists. Fraud experts can help make requisite adjustments to accurately value a business — and build a legal case, if necessary. Together, valuation and forensic accounting specialists can estimate economic damages resulting from fraudulent activity.

Beyond the scope

Business valuations typically aren't designed to unearth dishonest behaviors. However, valuation experts generally are on the lookout for signs of fraud and may, when necessary, expand the scope of an engagement to achieve an accurate conclusion. ■

In re Kinser Group LLC

Incorrect assumptions undermine hotel appraisal

Appraisals are often used in federal bankruptcy proceedings. But an expert's opinion is only as reliable as his or her underlying assumptions, as demonstrated by a recent decision by the U.S. Bankruptcy Court for the District of Arizona.

Hard times for hotels

The case involves two hotels located in a college town in Indiana. The town had only about 1,000 hotel rooms when the debtor purchased the hotels in 2017. By the end of 2020, the town had about 2,900 rooms. Population and visitor growth were static during this period.

COVID-related shutdowns adversely affected the hotels' financial performance. For example, October 2020 revenue fell $1.9 million from the prior year. Even before the pandemic, though, occupancy rates had fallen more than 25% for each hotel.

The debtor filed for bankruptcy on October 7, 2020. It subsequently filed a valuation motion to determine how to treat the bank's claims under the reorganization plan. The plan indicated the debtor would continue to operate the hotels, rather than dispose of them. So, the appraiser was required to determine the hotels' replacement value.

Dueling valuations

The debtor's appraiser found an aggregate fair market value of about $4.5 million for both hotels. The bank's appraiser came to a value that was approximately $3.7 million higher. The bankruptcy court found the bank's appraisals to be "fundamentally flawed" due to faulty assumptions.

Specifically, the bank's appraiser assumed the hotels would be sold in October 2020. This, the court said, rendered his appraisals defective for purposes of valuing a creditor's collateral. Under Section 506(a) of the U.S. Bankruptcy Code, value must be determined in light of the proposed disposition or use of the property.

The court also noted that the appraiser assumed a buyer would need to promptly spend $3 million to satisfy property improvement plans that hotel brand licensors would require. Those expected improvements, in turn, drove the appraiser's projected revenue numbers. In addition, the appraiser assumed that the improvements would be financed with capital reserves and capital contributions. However, the debtor had no capital reserves, and the reorganization plan didn't contemplate an imminent capital call.

As a result, the court concluded the properties weren't worth the proposed $8.2 million. Instead, they were worth about $5.7 million.

Bottom line

The court refused to accept the "overly rosy" projections of the bank's appraiser. Instead, it found the debtor's appraisal "more probable," particularly in light of the tight competition and short- and long-term damage of the pandemic. As this case shows, it's important to evaluate whether an expert's assumptions appear reasonable before you go to court. ■