



# Advocate's Edge

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**PLUS!** Business valuation checklist



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# Recovering the lost profits your clients deserve

Lost profits are a key component of damages in all kinds of litigation. In breach of contract and commercial tort cases, for example, a plaintiff may claim it suffered lower revenues, higher costs or both because of the defendant's wrongful conduct.

To accurately calculate lost profits, financial experts consider a number of factors, including lost revenues and variable costs, appropriate loss periods and discount rates, and mitigation of damages.

## Profit scenters

Financial experts use a variety of methods to sniff out lost revenues, often applying more than one in a single case. Among the most common are:

**The before-and-after method.** Here the expert compares the plaintiff's revenues before the defendant's act (or omission) to its post-act revenues, under the assumption that any decrease in revenues was caused by the defendant's conduct.

Generally, the expert assumes that operations and other relevant factors are comparable before and after the act. Adjustments may be necessary, however, for significant internal or external changes, such as a substantial cutback in the owner's hours or an industry downturn. To ensure a fair comparison of before-and-after business results, financial reporting methods should be consistent over time.

**The yardstick method.** With this approach, the expert compares the plaintiff's revenues to those earned by similar businesses or products, estimating the revenues the business would have earned if it had followed trends derived from comparable companies, market data or industry results.

But regardless of the method used, lost revenues are only part of the story. To arrive at lost profits, the

expert also deducts variable costs — such as the costs of goods sold — that the plaintiff would have incurred in generating those revenues. There are a variety of techniques for estimating costs, including cost accounting, industrial engineering and statistical methods, such as regression analysis.

## Damage control

Lost profits damages have their limits. They may be reduced, for example, if the plaintiff failed to take reasonable steps to mitigate its damages.

Financial experts can identify steps the plaintiff could have taken to mitigate damages and estimate their impact on the damage calculation.

In addition, plaintiffs generally can't recover lost profits damages into perpetuity. They're limited to the time period during which lost profits are directly related to the defendant's act. The loss period ceases when the plaintiff's business reaches the profit levels it would have attained but for the defendant's conduct.

As time goes by, of course, the causal connection between the defendant's act and the plaintiff's loss becomes more attenuated and more difficult to prove. Further, when forecasting damages into the future, an expert must account for inflation, fluctuating customer demand, and marketplace competition, and must discount lost profits to their present value.

## Value judgment

Business valuation professionals are particularly well suited to calculate lost profits. The processes and analyses closely mirror those used in business valuation, and valuers may possess extensive knowledge of the relevant industry and factors that affect a company's performance. ✧



## BUSINESS VALUATION CHECKLIST: WHAT DOES AN APPRAISER NEED?

Regardless of the reason for a business valuation, one fact is indisputable: The more information in the appraiser's hands, the more accurate the valuation. To obtain a business valuation that will stand up in court, attorneys need to ensure the appraiser receives access, at a minimum, to the following information for the company being valued.

### FINANCIAL DATA

- The previous five years' annual financial statements and balance sheets, and interim reports for the most recent quarters
- Forecasts of future earnings and fees
- Five years of federal and state income tax returns for the business and any subsidiaries, as well as payroll and sales tax returns
- Records of cash accounts and significant cash investments, including aged accounts receivable schedules with estimates of uncollectible receivables
- Quantity, description and costs of supplies and inventory, along with the pricing method applied
- Depreciation schedules for all real estate and equipment, with dates of acquisition, costs, depreciation method, useful life and accumulated depreciation
- List of liabilities and interest-bearing debt



- Operating, capital or fee budgets projecting future periods
- Compensation information, including stock options, deferred compensation and employee benefit plans

### OPERATING DATA

- List of owners and their respective shares
- Customer base and market size
- Product/service descriptions
- Supplier lists, including information on suppliers' financial status

### COMPANY DATA

- Patents, copyrights, trademarks and other intangible assets
- Contingent liabilities
- Property tax information
- Insurance policies
- Estimates of costs and timing for equipment and facility replacement

### INDUSTRY DATA

- List of all trade associations
- Trade publications and surveys related to the company's business

### LEGAL DOCUMENTS

- Foundational documents, such as articles of incorporation, bylaws and partnership agreements
- Loan and lease records
- Five years of board minutes
- Relevant contracts and agreements
- Key employment agreements
- Documents pertaining to current or pending litigation
- Reports from agencies such as the Occupational Safety and Health Administration, the Equal Employment Opportunity Commission and the IRS ✦

# Occupational hazards

## New report offers insights on employee fraud detection

Few organizations escape the reach of occupational fraud. The typical organization loses 6% of its annual revenues to employee fraud, and fraud losses in the United States total \$6.6 billion a year. Aside from prevention, detection should be the primary fraud-related goal of every business.

In its *2004 Report to the Nation on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) offers practical guidance on how to detect fraud.

### Tipping the scales

According to the ACFE's report, which is based on an analysis of more than 500 fraud cases, tips were by far the most common detection method. Most tips come from employees (60%), but tips from customers, vendors and anonymous sources were also significant, each representing between 10% and 20% of those reported.

Tips were also the most effective method of detecting losses of \$1 million or more — internal controls caught only 8% of large frauds.

Still, many organizations with fraud reporting mechanisms don't make them known or available to third parties, who often are in the best position to observe fraudulent behavior.

### Staying in control

Strong internal controls can significantly deter fraud, the ACFE found. Nonetheless, internal controls ranked only fourth, after "by accident," on the list of most common fraud detection methods. Further, the median loss uncovered by internal controls was only \$40,000, compared to \$140,000 for accidental discoveries.

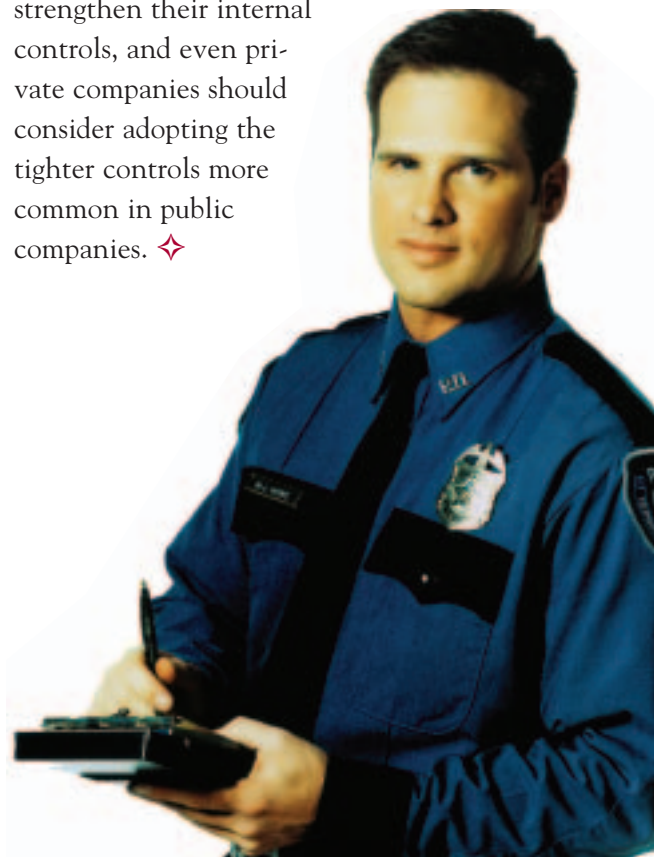
Many of the most costly frauds are committed by owners and executives, but internal controls are less effective against these frauds because the perpetrators usually have the ability to override them. About half of owner/executive frauds are uncovered through tips.

Public companies enjoy the most success catching fraud through internal controls. About 30% of frauds in these companies are detected by internal controls, compared to only 15% for privately held businesses.

The low ranking of internal controls as a fraud detection tool suggests that businesses — especially closely held ones — need to implement better internal controls to prevent and detect fraud. The lower median loss for frauds detected by internal controls seems to validate the effectiveness of these procedures.

### Recommendations

Employee fraud can potentially devastate a business, so attorneys should advise their clients to implement comprehensive antifraud programs. As a first step, businesses should establish anonymous reporting mechanisms. Businesses also should strengthen their internal controls, and even private companies should consider adopting the tighter controls more common in public companies. ✧



## WHO COMMITS FRAUD?

In its recent study (see “Occupational hazards” on page 4), the Association of Certified Fraud Examiners (ACFE) cited several factors that correlate with an employee’s likelihood to commit occupational fraud and may indicate the size of the loss:

**Position in the organization.** As a fraud perpetrator’s level of authority increases, so does the amount of the associated loss.

**Annual income.** The size of the fraud generally increases with the perpetrator’s annual income. Fewer than 5% of the cases in the ACFE study involved a perpetrator earning more than \$200,000 per year, but in those cases the median loss exceeded \$1 million.

**Tenure with the organization.** The report found a direct correlation between a perpetrator’s term of employment and the size of the loss. The ACFE attributes this to the fact that employees gain higher level positions over time and, perhaps more important, greater trust from supervisors and co-workers. The more an organization relies on an employee, the more authority that employee exercises, in turn increasing the opportunity to commit fraud.

**Gender.** Perpetrators in the 2004 study were almost evenly split between males and females, although the median loss was greater in schemes carried out by men.

**Age.** The ACFE found a direct link between the age of the perpetrator and the size of the loss. Forty-nine percent of perpetrators were over 40 years of age, and only 17% were under 30.

**Education.** About half of the perpetrators failed to go beyond high school, 42% earned bachelor’s degrees and only 9% boasted postgraduate degrees. But as the perpetrators’ education levels increased, so did the size of the fraud loss.

**Number of perpetrators.** About two-thirds of the cases in the ACFE study were committed by a single perpetrator. When multiple perpetrators participated in a scheme, the median loss rose dramatically.

**Criminal history.** Most of the perpetrators were first-time offenders, suggesting that employee fraudsters typically aren’t career criminals.

# The Dirty Dozen

## IRS warns of common tax scams

In the latest installment of its annual consumer alert on tax scams and other schemes, the IRS warns taxpayers to avoid promoters who promise to eliminate or significantly cut their tax liabilities. In particular, the IRS urged taxpayers to avoid 12 common schemes — the so-called “Dirty Dozen.”

**1. Misuse of trusts.** In this scheme, promoters encourage taxpayers to transfer their assets to one or more trusts. They promise a range of tax benefits, including reduction of taxable income and deductions for personal expenses paid by the trust.

The IRS warns that such abusive trust arrangements won’t produce the advertised benefits.

**2. “Claim of right.”** In an emerging scheme, promoters advise taxpayers to file tax returns claiming a deduction equal to the entire amount of their wages, instructing them to identify the deduction as “a necessary expense for the production of income” or “compensation for personal services actually rendered.” The IRS says the deduction has no basis in law.

**3. Corporation sole.** The concept of corporation sole was created to allow religious leaders, such as bishops, to incorporate as individuals to avoid legal liability related to ownership and control of church assets. The individual becomes exempt from federal income taxes as a nonprofit religious organization. But, contrary to promoters' assertions, corporation sole laws don't provide a legal way for others to evade federal income taxes, child support or other personal debts.

**4. Offshore transactions.** The IRS reminds taxpayers that using an offshore bank account, brokerage account, credit card, wire transfer, trust, offshore employee leasing arrangement or other means to hide or underreport income or claim false deductions is illegal.

**5. Employment tax evasion.** There's been an increase in schemes that direct employers not to withhold federal income tax or other employment taxes from wages paid to employees. These schemes have been rejected by the courts and the employers have been found liable for back payments. Plus, the employees remain responsible for paying their personal taxes.

**6. Tax preparer fraud.** Unscrupulous tax return preparers divert part of their clients' refunds for their own benefit. They may also charge inflated fees and falsely guarantee larger refunds. Unfortunately, taxpayers assume ultimate responsibility for all information included on their returns, even if they're prepared by a "professional."

**Taxpayers can deduct business expenses only when a clear business purpose and profit motive exist.**

**7. ADA credits.** Promoters encourage taxpayers to buy equipment and services they falsely claim qualify for the Disabled Access Credit established by the Americans with Disabilities Act (ADA). The taxpayers make a minimal payment, sign a nonrecourse note and provide

insignificant services to complete the purchase agreement.

**8. Slavery reparations.** Promoters have misled thousands of black people, offering to file for tax credits or refunds related to reparations. No such credits or refund provisions exist under current law, and taxpayers could incur a \$500 penalty for filing these claims if not withdrawn.

**9. Improper home-based businesses.** Promoters claim taxpayers can deduct most or all of their personal expenses as business expenses by establishing fake home-based businesses. The IRS points out that taxpayers can deduct business expenses only when a clear business purpose and profit motive exist.

**10. Frivolous arguments.** A "frivolous argument" is a false argument unsupported by law. It includes advertisements claiming a promoter knows the "secret" to never paying taxes again or offering "untax packages" for a fee.

**11. Identity theft.** You've probably heard horror stories about identity theft — a crook uses victims' personal data to raid their accounts, charge large purchases, apply for loans and credit cards, and otherwise wreak havoc on their financial stability and credit histories. Some perpetrators use bogus IRS forms to induce taxpayers to disclose personal data and banking information.

**12. Sharing EITC dependents.** Some unscrupulous tax preparers have convinced taxpayers to "share" their qualifying children with other taxpayers so both can claim the Earned Income Tax Credit (EITC). For example, a taxpayer with four children, who only needs to claim two for the credit, lets another taxpayer claim two of the children on his or her return to earn the credit.

The IRS and other federal agencies aggressively pursue and prosecute both promoters and their clients involved in fraud and tax evasion schemes. Taxpayers who participate in the Dirty Dozen and similar scams face the possibility of imprisonment, fines and repayment of taxes owed with interest and penalties. Even innocent victims become subject to costly interest and penalties. Consulting with a tax advisor could protect your clients from these devastating consequences. ✧

# Court awards spouse share of postfiling earnings

In a recent case, a New Jersey court broke from long-standing precedent for valuing marital assets in a divorce case. Rather than valuing the assets as of the time the divorce was filed, the court found the wife was entitled to a share of her husband's dramatic business growth over the following eight years. In *Ciasulli v. Ciasulli*, the wife ended up with an award of \$35.8 million, plus alimony and fees.

## A gift for business?

Adele Ciasulli filed for divorce in 1994, after 30 years of marriage. During the marriage, her husband, Bob Ciasulli, acquired a 50% ownership interest in his father's business, a group of auto dealerships.

Bob claimed the interest was a gift, but the court found that the evidence clearly showed Bob earned this interest by working for his father for more than 20 years and making a cash investment. When his father died in 1984, Bob exercised an option to buy his father's interest, giving him 100% ownership.

From 1994 to 2002, the business's profits skyrocketed, with annual sales eventually reaching more than \$360 million.

## Passive or active?

Adele's attorney asserted that the business's assets were passive, meaning fluctuations in their value were based on market conditions. But businesses are typically considered active assets, whose values are affected by their owners' contributions and efforts.

The court agreed that the increase in the value of the business was better characterized as passive, finding that its profitability was primarily attributable to economic conditions, not Bob's management efforts. The court recognized that Bob contributed to the business's success to some extent, so it granted him 65% of the increased value. Adele received 35%.



## Bad faith in action?

The court chastised Bob for acting in bad faith, awarding Adele her attorneys' and expert fees. Bob's effort to portray his original 50% interest as a gift, the court said, was an "attempt to immunize part of [the business] from equitable distribution."

Plus, at the time of filing, Bob reported his net worth at \$47 million, only to revise it down to \$19.6 million six months later. The court also accused him of retaining a valuation expert solely to undervalue the business, thereby depriving Adele of her fair share.

## Just an aberration?

It's doubtful that many courts will depart from the traditional approach of valuing marital assets at the time of filing. But *Ciasulli* isn't the first case to hold that special circumstances can justify using a later date to achieve equity.

Attorneys should keep these possibilities in mind. They should also ensure their clients don't attempt to manipulate business valuations. The consequences can prove costly, as Mr. Ciasulli learned the hard way. ✧



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