

## Fraud Deterrence - Protecting Your Assets and Information

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Partner

Unfortunately, fraudulent activity targeted against business entities is escalating. We've all seen notorious cases fill the news, but there are countless smaller fraud schemes that occur, only some of which are prosecuted. In a recent study conducted by the Association of Certified Fraud Examiners (ACFE), participants estimate that U.S. organizations lose 5% of their annual revenues to fraud. This represents approximately \$652 billion in fraud losses when applied to the U.S. Gross Domestic product.<sup>1</sup> Black's Law Dictionary defines fraud as:

*A general term, embracing all multifarious (various) means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning dissembling, and any unfair way by which another is cheated.*

### Three types of fraud may occur:

- Financial Reporting Fraud (caused by management) - these types of fraud schemes involve manipulation of financial results, which serve to benefit the perpetrator in some manner, such as performance bonuses.
- Misappropriation of Assets (caused by employees) - fraud schemes used to steal money or inventory for personal gain.
- External Fraud - schemes generated by persons outside of the company.



**There are many reasons for this increase in crime, but this article will specifically address two of them:**

- Need and greed
- Lack of internal controls and monitoring

### Need and Greed

The basic fraud triangle consists of motive or purpose, opportunity, and rationalization. Fraudsters may be tempted to embezzle because of personal or family financial pressures such as a drug habit, gambling problem, excessive spending, or an uninsured illness for themselves or a family member, just to name some examples. Opportunity is present when the system of internal control is weak and the fraudster seizes the chance to perpetrate a fraud scheme. Once assets have been misappropriated, the thief usually conceals the activity and often rationalizes internally that they are being underpaid, will pay the money back as soon as they can, or develop another reason that what they did is acceptable.

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<sup>1</sup> 2006 ACFE Report to the Nation on Occupational Fraud & Abuse.

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## VFL Team News

### New Partner-NYC



Eric A. Kreuter recently joined our team as a VFL Services Partner in our Manhattan office. Eric brings to BST a wide range of skills and credentials. He specializes in litigation and forensic services, including fraud investigations and is a specialist in all facets of the construction industry. Eric has testified in State Court, U.S. Bankruptcy Court as well as arbitrations and depositions. He has published several books, book chapters and numerous articles covering a wide range of topics. In addition to being a Certified Public Accountant, Eric is also a Certified Management Accountant (CMA), Certified in Financial Management (CFM), a Certified Fraud Examiner (CFE), a Certified Forensic Financial Analyst (CFFA), a Diplomate and Fellow of the American College of Forensic Accountants, and Board Certified in Forensic Traumatology. Eric has a Bachelor of Science degree from Manhattan College, a Master of Arts degree in Industrial Psychology from Long Island University and a doctorate (Ph.D.) in Clinical Psychology from Saybrook Graduate School and Research Center.

### Another CFE



Edward T. Dominelli recently joined our team as a Senior Consultant following more than 32 years service with the State of New York in a variety of investigative and auditing capacities. His most recent position was with the NYS Dormitory Authority as Director of Internal Affairs responsible for fraud prevention and internal investigations relating primarily to the Authority's multi-billion dollar capital construction program for such clients as the City University of New York, State University of New York, Unified Court System, NYC Health and Hospitals Corporation and NYS Office of Mental Health. Along with his team of investigative auditors, Ed's office developed and implemented a comprehensive corporate integrity and fraud prevention program for the Authority and its many contractors and consultants. In addition to internal disciplinary and Title VII investigations, his office, in conjunction with law enforcement and prosecutorial agencies, conducted numerous criminal investigations involving employee corruption, contractor/consultant procurement/contract fraud and M/WBE compliance fraud. He has a Bachelor of Arts degree from SUNY Plattsburgh and a Master's Degree in Public Administration from SUNY Albany and he is a Certified Fraud Examiner (CFE).

When it comes to Fraud



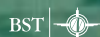
Nobody Wins.

If you suspect fraudulent activity:

Call the Confidential Hotline, Toll-Free:  
**(866) 430-9404**

or

Submit the Confidential Online Form at:  
**[www.bstco.com/fraud](http://www.bstco.com/fraud)**



**Fraud Hotline** – As part of our commitment to developing services that meet client needs, we are pleased to announce the addition of a confidential fraud hotline to our portfolio of Business Integrity and Forensic Services. The hotline, available to non-attest clients, provides 24/7 access to a confidential toll-free phone number, and secure on-line web form, through which employees can anonymously report incidents of suspected fraud or employee misconduct. A study in 2006 by the Association of Certified Fraud Examiners (ACFE) found that the anonymous tip was the most common way unethical employee conduct was detected within organizations. According to the ACFE study, the median fraud loss per scheme was \$100,000 for organizations employing a hotline and \$200,000 for those without a hotline in place. Please contact Chris Rosetti or Ed Dominelli for additional information.

Team Member  
Promotions –

We are very pleased to announce the recent promotions of Charles Amodio and Pam Wickes to Senior Manager and Paul Zarecki and Debbie Zlotnick to Manager.

# Evaluating Business Damages - What Should You Consider?

Stephen L. Ferraro, CPA/ABV, CFFA, CVA  
Partner

In matters involving business damages, a valuation expert commonly constructs financial models that depict his or her analysis and resulting damages opinion. Understanding the elements of these models and how to evaluate them can give you a decisive edge in your damages cases. Let's examine the business damages model -- what it is based upon, how it is used and its potential strengths and weaknesses.



## Damages to Consider...

A business damages model typically incorporates historical company data, economic and industry research, industry data averages, revenue drivers, assumptions and projections, which, when taken together, establish the valuation expert's opinion. The damages the valuator considers can usually be broken into four main categories:

1. Loss of past (pre-trial) profits,
2. Loss of future (post-trial) profits,
3. Loss of business or intangible value, and
4. Out-of-pocket costs.

In evaluating the expert's model, it is important to address each of the categories separately, because each may be based on different data, variables and assumptions. For example, "loss of future profits" is based upon a prediction of events yet to occur. The prediction may be based on careful and thorough research or it may be based upon pure speculation. "Out-of-pocket costs," on the other hand, are usually based on hard evidence of actual expenditures made in the past. Accordingly, considering the quality of the data, the reasonableness of the assumptions and the soundness of the projections become important when evaluating the components of an expert's damages model -- and the resulting opinion.

## Questions to Consider...

Here are several questions to consider in evaluating an expert's damages analysis:

### Does the expert have a solid foundation for the revenue, expense and earnings growth rates used in calculating his or her projections?

It is not uncommon for a damages expert to merely assume that the future growth rate will be equivalent to the company's actual growth rate experienced over the past three to five years. When simply calculating or averaging a historical rate, the expert ignores changes in the economy, the industry and the company's operations. A well-prepared expert recognizes the significance of each of the important revenue drivers and other variables that affect a company's growth.

### Did the expert consider the components of the company's cost structure, or did the expert simply use average cost, margin and profit percentages?

A proper analysis involves breaking down the company's expenses between fixed expenses (those that typically do not fluctuate with sales volume, such as rent, depreciation and administrative salaries) semi-variable expenses (those that may fluctuate with sales volume, but not directly, such as supervisory costs and certain overhead expenses) and variable expenses (those that fluctuate directly with sales volume, such as materials and factory labor). Using average percentages frequently renders an expert's analysis incorrect, because it does not acknowledge the true nature of expenses.

### Did the expert speak with or contact persons other than the litigants in gathering his or her data?

Keep in mind that litigants are often unable to take an objective view of the underlying data. Accordingly, litigants may provide their experts with data that supports only their side of the case. Important documents, management reports, customer information and correspondence may have been selectively withheld from the expert in the interest of skewing the results of the expert's analysis. The information that an expert has failed to consider provides fertile ground for effective cross-examination.

### Did the expert apply his or her methods in a sound and reliable manner?

With the advent of the electronic spreadsheet (for example, Microsoft® Excel) the damages expert has a broad assortment of financial and statistical analysis tools available at the click of a mouse button. But he or she may choose to apply one of these formulas without really understanding how it works. The result is that an otherwise impressive set of calculations may have such a high rate of error as to render it meaningless.

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Sometimes, after a small amount is taken, the fraudster becomes emboldened and increases the complexity and duration of the scheme. Multiple schemes may also be conducted where the environment is particularly vulnerable and the fraudster becomes greedy.

Company information is also very valuable and should be protected. This may include records of employee identity, customer lists, bidding history for construction contractors, and other key data.

### Lack of Internal Controls and Monitoring

The internal control system is the key to minimize opportunities for fraud to occur. Complementary to a robust system of internal control is a dynamic statement made by ownership that fraud will not be tolerated and violators will be prosecuted. The perceived



integrity of the company will have a significant impact on the integrity of the workforce.

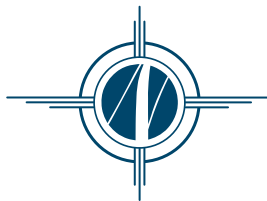
Even a well-designed system of internal control should include a degree of monitoring. This includes routine tests that the systems of control are effective in their mission to deter fraud. An example is to make sure that there is adequate segregation of duties so that there is more than one person handling any particular cycle of operations.

As a way of combating the prevalence to steal, companies are urged to consider the various means whereby assets may be stolen and what control systems are in place to prevent theft. If there is a perceived weakness, the internal control system should be improved. Thus, by conducting background checks on new hires, establishing policies designed to reinforce the commitment to corporate integrity and through the establishment of cost-effective internal controls, corporate assets may be better protected from unauthorized use.

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