



## **Factoring fraud into the business valuation equation**

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 inflate (or decrease) the value of the business, depending on which serves their financial interests.

Business valuations typically are *not* designed to unearth dishonest behaviors. However, experts need to be on the lookout for signs of fraud and, when necessary, expand the scope of the engagement to achieve an accurate conclusion.

## **Fraud risks**

Value is a function of risk and return. One critical risk factor experts consider is fraud. Some businesses are more vulnerable to fraud than others.

The fraud risk assessment starts with a company's internal controls. When interviewing management, business valuation experts ask about the company's policies and procedures to protect assets, improve operating efficiency and ensure reliable financial statements. A company's first line of defense against fraud is a strong system of internal controls, which may include:

- Physical and digital controls (for example, locks, passwords, cameras and security systems),
- Fraud training programs,
- Job descriptions that call for segregation of duties and job rotation,
- Mandatory vacation policies,
- Background checks, and
- Whistleblower hotlines.

Internal controls can be intentionally circumvented and thus are less effective if managers override the systems 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.

Certain industries also tend to be more susceptible to fraud than others. High-risk sectors include banking and financial services, government and public administration, and manufacturing,

