Signs of Fraud

Commercial Finance Association

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I. Fraud: The Warning Signs

A. Focus on enterprise-wide fraud

1. Originates at the executive level of the borrower.
2. Two types
   - a) "Pig thru a python."
     - 1) Traditional or "old school" – pre-computerization type fraud;
     - 2) Easier to spot;
     - 3) Difficult to carry on for an extended period;
     - 4) Usually smaller in scope than second type below.
   - b) Fraud grafted on top of a real business
     - a) Much more difficult to spot - on the surface - it is transparent;
     - b) Carried on for years; and
     - c) the worse news yet – it's pervasiveness
     - e) Usually much larger than (a), above.

B. Indicia of fraud?

External Market / Industry Factors:

1. Rapid or chronic sectoral and industry-specific downturns.
   - your borrower is bucking the trend, and you can't figure out why.
2. Significant regulatory changes requiring major operational adjustments.
   1) Your borrower is highly resistant and / or
   2) Your borrower engages in delay tactics (SOX may be a precursor).

C. The borrowing base

1. Credit line maximized consistently / minimal or no availability;
2. Liquidity problems / chronic cash flow shortages;
3. The company has frequent or chronic overdrafts;
4. Consistent financial default and waivers;
5. "Mysteries" and / or "stories" in the A/R or inventories;
6. Components of working capital are not moving together / aberrant movement;
7. Inventory in-transit is not reasonable *e.g.,* it's 60% of inventory;
8. The components of inventory and A/R are not aged or the aging is unreliable;
9. The line of credit is the biggest number on the balance sheet – line of credit is disproportionate to trade payables;
10. There are no alternative lenders and / or investors;
11. The 20% of inventory that is moving is contracting while its turn velocity is increasing;
12. Does the cash come from account debtors?;
13. Inventory quantities do not support the balances reported.

D. Operations

1. The realities of the physical operation do not reflect the financial activity that is being reported *e.g.,* a $400,000,000 borrower appears to move $100,000 a day;
2. The stats *e.g.*, volumes, A/R & inventory turnover data, margins, shipments, etc. are not consistent with who they are - their numbers say they are in the top tier of their industry but their cost structure, pricing and margins say that they have an inconsequential share.

E. Annual audit problems

1. The audit takes forever or is <u>unbelievably</u> quick;
2. The audit is always delayed;
3. You get the feeling that the auditors should be audited;
4. You are relying on the auditors and they are relying on you;
5. You are relying on the auditors and but you don’t have a clue as to the scope of their audit;
6. Significant post-closing adjustments;
7. Audit adjustments;
8. Revenue recognition, inventory costing, obsolescence, purchase cut-off, sales cut-off and payroll issues identified in the audit;
9. Historical disagreements between management and auditors on A/R collectability, inventory obsolescence, contingent liabilities and slow-moving inventory adjustments.

F. Financial reporting, accounting, controls environment and accounting staff issues

1. Abrupt resignation of all or some of the finance staff;
2. Frequent turnover among the finance staff;
3. Recent or frequent change(s) in CPAs;
4. No written accounting procedures or not adhering to existing procedures, e.g. not reconciling cash, not reconciling the perpetual inventory report to the general ledger;
5. Books and records are a compilation of Excel schedules and QuickBooks;
6. Cash is all over the place and there does not appear to be control over the cash accounts;
7. Uncertain as to whether major vendors and customers are solvent;
8. Expenses capitalized and CapEx expensed;
9. There are revenue recognition, inventory costing and other GAAP issues;
10. Significant post-closing adjustments;
11. The books, records and reports provide a fog bank instead of visibility;
12. When you ask for a forensic image of the accounting database (because you have your doubts) it turns out this is a big problem for the borrower … and probably a big problem for you;

G. Management transgressions and sins

1. Owner uses the company like a piggy bank;
2. Excessive trade credit extended to account debtors;
3. Overly complicated organizational structure;
4. A CFO or other manager who won't allow access to staff (wants to control information flow);
5. Serial bankruptcy filings;
6. Management is not responsive / cooperative / helpful;
7. Management's answers to reasonable questions do not make sense;
8. Reasonable questions receive the response "you don't understand my business" from management;
9. The borrower refinances every couple of years to avoid insolvency.

H. Sales cycle red flags

1. You don't know or recognize the customers;
2. The vendors ***<u>are</u>*** the customers;
3. You don't have enough visibility into operations, affiliates, related parties, and others to evaluate whether the vendors and customers overlap;
4. The president handles a material amount of the customers;
5. Significant amount of credit is extended to customers you've never heard of;
6. Special year-end terms and significant sales.

I. 3rd party documentation concerns

1. The records do not tie to the goods;
2. Bills of lading do not track with invoice data;
3. Inadequate freight charges;
4. No recognizable 3rd party freight carrier involved;
5. Same signatures over and over on transportation and other documents;
6. No purchase orders received for many "sales".

J. **PAAP** ("Pants Around Ankles Phenomenon")

When it turns out there is a fraud you are shocked because:

1. The auditors gave the borrower a clean audit opinion;
2. Your own routine collateral audits surfaced no problems;
3. You don't have enough muscle in the loan agreement to get what you need to liquidate.

II. Remedies & Recoveries

A. Traditional Remedies

1. Borrower
   a) Receivership
   b) Attachment
2. Guarantor
3. Third Party Claims

B. Claims Against Accountants

1. Audited/Certified Financial Statements
2. Materially False
3. Lender was “Intended Beneficiary”
4. Lender Relied on Financial Statements
5. Lender Suffered Damage

C. Practical Issues

1. Language in Loan Documents
2. Timing
3. Obtaining Work Papers
4. Mediation

- Investigative accounting and consulting firm.
- 25 years of operations.
- National practice.
- Multiple industries.
- Five major services areas:
  - Litigation Consulting (economic damages, accounting malpractice, etc.)
  - Bankruptcy (creditor's rights, expert testimony, financial advisor, etc.)
  - Due Diligence (go/no-go, pricing and structural financial determinations).
  - Loan Workouts (financial triage, forensic accounting, fraud investigation, etc.)
  - Portfolio Evaluation.
- CPAs, accountants, MBAs – audit, finance and operating executives.
- 25 to 35 years hands-on experience.
- CFOs, controllers, CEOs – understand intricacies of financial reporting and areas of concern.
- Organizationally lean – little leverage.
- Serving lenders, private equity groups and their counsel.
- Focus on adding value – rendering the complex understandable, building long-term relationships:
  - Combining forensic accounting and legal services to achieve **RECOVERIES**.

Debt & Equity Sources

- BNP Paribas
- Centre Partners Management
- Citibank
- CIT
- Comerica
- Falcon Investment Advisors
- Goldman Sachs Specialty Lending Group
- GE Capital
- GMAC
- Harris Nesbitt (Bank of Montreal)
- ING Barings
- J.F. Lehman & Company
- Key Principal Partners
- LaSalle Business Credit
- Praesidian Capital LLC
- Union Bank of California
- Wells Fargo Bank
- Whitney & Co., LLC
- Wachovia Capital Finance

Law Firms

- Bodman, Longley & Dahling
- Buchalter, Nemer, Fields & Younger
- Edwards & Angell
- Katten Muchin Zavis & Weitzman
- Latham & Watkins
- Morrison & Foerster
- Otterbourg, Steindler, Houston & Rosen, P.C.
- Sheppard Mullin Richter & Hampton
- Winston & Strawn

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