fraud alert

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Contemplating a merger? Don’t get blindsided by fraud

Mergers are like marriages: Success depends on any number of factors, but failure may be a result of one overriding flaw. In the case of mergers, that flaw often is lack of thorough due diligence. With investors, lenders and other stakeholders noticeably skittish in the wake of corporate accounting scandals, it’s more important than ever that you know whom you’re marrying before you walk down the aisle.

Companies that demand unreasonable financial performance from their managers are more likely to be defrauded.

You may be able to get some of the information you need about a potential acquisition from public documents and interviews with senior executives. When it comes to unearthing creative accounting practices and fraud, though, you may want to call in help. Forensic accountants know where and how to look for financial irregularities that could prove fatal down the road.

An antifraud culture

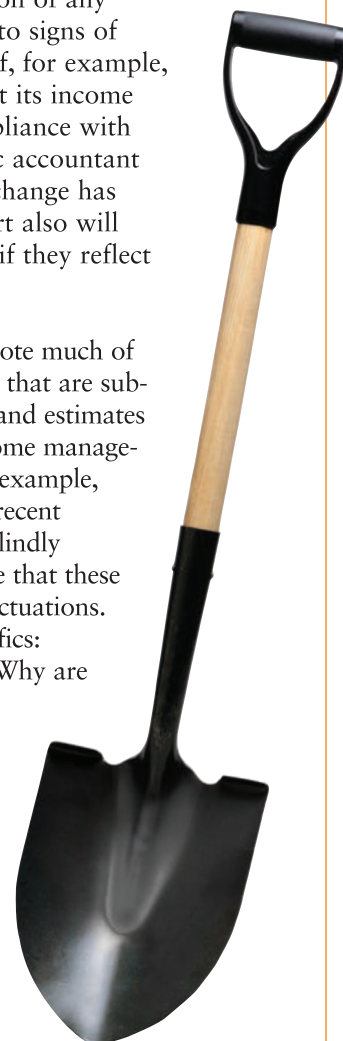
Premerger due diligence begins with your own assessment of a potential acquisition’s corporate culture. One warning sign is a company that hasn’t demonstrated a commitment to fraud prevention or implemented best practices for governance. It’s important that the organization have well-defined and regularly reinforced codes of ethics, as well as strong internal controls that are periodically reviewed and tested for compliance.

Another potential problem is a management team that doesn’t communicate well. A CFO with an intimidating or dictatorial management style, for example, might feel free to bend accounting rules because other employees are too fearful to question his actions.

Of course, any effective due diligence includes intensive scrutiny of corporate, financial, tax, loan and regulatory records. It should encompass short-term debt retirement capabilities, liquidity, profitability and the ability to meet long-term obligations. This is where an experienced forensic accountant can add value to the process.

Digging for dirt

Experts look for documentation of any financial claims and are alert to signs of cleverly hidden shenanigans. If, for example, a company says it has brought its income recognition policies into compliance with new SEC standards, a forensic accountant will consider what effect the change has on previous figures. The expert also will examine earlier figures to see if they reflect any financial irregularities.



A forensic accountant may devote much of his or her attention to earnings that are subjective, too. Reserves, accruals and estimates all can be manipulated for income management purposes. If accruals, for example, have increased significantly in recent months, it’s important not to blindly accept the company’s assurance that these increases are due to normal fluctuations. Forensic experts insist on specifics: What causes the fluctuations? Why are they handled this way? Is there a better approach? If so, why isn’t it being followed?

Experts also look beyond the numbers and examine the opportunities and potential reasons for fraud or misstatement. Companies that demand unreasonable financial

performance from their managers, for example, are more likely to be defrauded than are companies with realistic expectations.

No hiding, please

Forensic accountants can discover hidden liabilities, overvalued receivables or securities, understated liabilities, and overstated inventories — any or all of which can create an inaccurate picture of a company's true value. Signs of potential fraudulent reporting include:

- Excessive restrictions on auditors,
- Material (more than 5% of market value) related-party transactions,
- Individuals or executive "cliques" dominating corporate management,
- High employee turnover, and
- Excessive tax-driven earnings reductions.

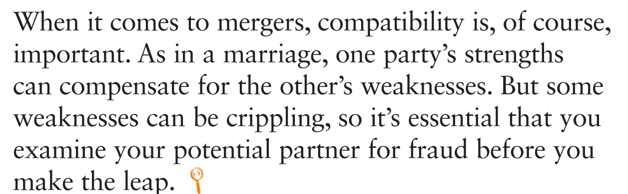
Any of these may be significant, but limiting auditors' access to data, senior executives or operational personnel generally is considered a sign that something is amiss.

Get the word out

One mistake many companies make during merger and acquisition transactions is overlooking the importance of a good communications strategy. Employees — especially if they're also shareholders — investors, lenders, customers and suppliers all want to know how a merger will affect them. Explain in as much detail as necessary why the deal makes sense and how it will benefit stakeholders.

Early on, determine how you'll describe strategic goals, as well as how you'll communicate, monitor and report progress toward them. Don't be overly optimistic, but attempt to minimize uncertainties and avoid undue disruptions. Be honest about the effects you expect the merger to have on earnings and return on invested capital — and then let the world know whether you were right. If problems arise, address them openly.

If a merger begins with negative perceptions outside the inner circle of top executives, it can be difficult to turn those perceptions around. Mergers are complicated, but they're not — or shouldn't be — top secret. Communicating what you can as soon as you're able will help you avoid undue pressure to turn in unreasonable numbers once you've signed the deal. And pressure to perform is the last thing you need if you want to avoid fraud.



More than compatibility

When it comes to mergers, compatibility is, of course, important. As in a marriage, one party's strengths can compensate for the other's weaknesses. But some weaknesses can be crippling, so it's essential that you examine your potential partner for fraud before you make the leap.

Flight of the phoenixes

Vigilance may help ground fraudulent companies

When a company goes bankrupt, honest owners or directors do everything they can to hold creditors' losses to a minimum. When it becomes clear the business can't be saved, they halt trading (in the case of public companies), hire professional advisors to help guide them through bankruptcy proceedings and generally arrange for orderly liquidation.

Less scrupulous people use somewhat different tactics. They may, for example, deliberately sell off assets so there isn't enough left of the company to justify creditors bringing in turnaround or bankruptcy experts. Worse, they may attempt to profit from bankruptcy. Knowing how to spot these "phoenix" companies can help prevent you from getting burned.

A rose is a rose

Owners of a bankrupt company might sell the assets to themselves as owners of a new company that is in the same or related business. The new company may even have the same or a similar name. There's nothing wrong with such companies

if some or all of the directors or owners buy the assets at fair market value and use them to attempt to build a financially strong successor company.

There is something wrong, however, if the principals intentionally ran the old company into the ground to avoid liabilities, or if they transferred assets to the new, phoenix company at below-market value shortly before or immediately after the demise of the original business. Those are just some of the signs that fraud is afoot.

According to a report from the International Association of Insolvency Regulators (IAIR), phoenix companies are becoming less common as tighter regulations force more accurate financial reporting among both public and private companies. The report adds, however, that because there are legitimate reasons for solvent businesses to establish subsidiaries or parallel operations, it can be difficult to detect phoenix activity until the transfer of assets, customers and goodwill has been completed.

Smelling a rat

Signs of trouble may be apparent to those who look carefully. Phoenix companies often are formed with minimal share capital, for example. Also be wary when:

- A company opens its doors either immediately before or within a year after the failed company has publicly stated its imminent demise,
- Some or all of the directors and other senior executives and many employees of the debtor business now work for the new company,
- A number of preferential payments are made to creditors of the insolvent company before it goes out of business so that those creditors will be more willing to supply the new company, and
- Substantial liabilities are left in the insolvent company when the new business is formed.

Before agreeing to do business with these new companies, potential customers and suppliers should check business references, scrutinize directors' and owners' backgrounds, and learn why the original business failed.

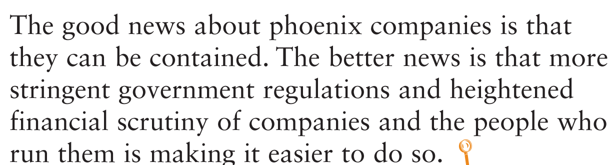
Catching the perpetrators

While there are civil and criminal remedies for creditors to pursue against phoenix companies, unsecured creditors of the bankrupt business are most likely to suffer. Creditors are most likely to spot potential phoenix activity early, but they may not take action after operators of the phoenix business pay outstanding bills in an effort to keep supply lines open.

There are no definitive statistics on the incidence of phoenix companies, in part because bankruptcy fraud often is perpetrated in conjunction with other types of fraud. Because fraud investigations can be complex and time-intensive, bankruptcy fraud may not be included in indictments if evidence of tax fraud or embezzlement is sufficient for criminal convictions.

The IAIR report says, however, that phoenix companies are most common in the construction, transportation, hospitality, and clothing and textile industries. Of course, that doesn't mean phoenix companies don't crop up in other industries. No sector is immune to fraud.

Controls work



The good news about phoenix companies is that they can be contained. The better news is that more stringent government regulations and heightened financial scrutiny of companies and the people who run them is making it easier to do so.

Use anonymous hotlines to cool fraud

If you don't think fraud hotlines are essential to your business, consider the following statistics: In the fiscal year ending in September 2006, whistle-blowers alerted officials to $1.3 billion in fraud against the government, according to the Department of Justice. And the Association of Certified Fraud Examiners (ACFE) reports that, between January 2004 and January 2006, tips from employees or anonymous sources led to detection of 34% of the occupational frauds investigated. There are several ways to facilitate fraud reports, but one of the easiest and most effective is through anonymous hotlines.

For private companies, too

The Sarbanes-Oxley Act requires publicly traded companies to have confidential, anonymous reporting systems for employees to report possible misconduct. Even though privately held companies aren't required to implement fraud hotlines, they're doing themselves a disservice if they don't. According to the ACFE, U.S. companies lose more than 5% of their revenue to fraud every year, and the average fraud scheme goes undetected for 18 months. Organizations with fraud hotlines, however, cut their losses by half — from a median of $200,000 to $100,000.

But to be effective, hotlines must be properly set up and operated. If employees aren't assured their reports will remain confidential or anonymous, they're likely to remain silent about what they know or suspect. Similarly, if your tip hotline is open only during business hours, employees won't use it.

Avoid voicejail

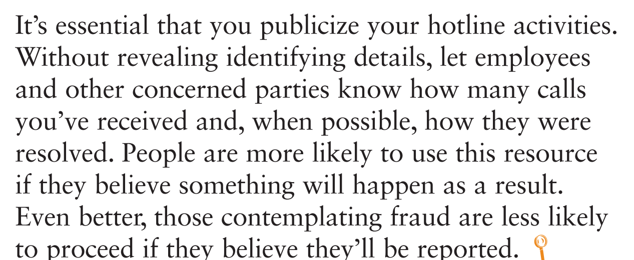
Companies that are serious about using their hotline to prevent fraud make it available 24 hours a day. People often decide to report suspicious activities late in the evening or early in the morning. What's more, effective hotlines are staffed by trained professionals, because, when tipsters call, they're likely to be upset or angry and may, therefore, need to be handled with sensitivity.

If tipsters are asked to leave a message, many will hang up. Others might report that their supervisor is stealing from the company, but won't leave enough information for you to identify the supervisor, the caller, the department or how the theft is occurring. If an interviewer takes the call, he or she can extract the information you need to investigate — without compromising the caller's anonymity.

When you establish a hotline, make it available to customers and vendors as well as employees. Communicate not only that it exists, but also how it should be used: what types of activities should be reported, and the basic information that must be supplied to initiate an investigation.

Also, establish a plan to ensure the proper people receive any hotline tips. Your human resources department, for example, may receive sexual harassment or discrimination complaints, while allegations of fraud or financial irregularities may be routed to your attorney or outside auditor.

Be visible



It's essential that you publicize your hotline activities. Without revealing identifying details, let employees and other concerned parties know how many calls you've received and, when possible, how they were resolved. People are more likely to use this resource if they believe something will happen as a result. Even better, those contemplating fraud are less likely to proceed if they believe they'll be reported.

Trust, but verify

How to guard against bookkeeping fraud

The bookkeeper is one of any company's most trusted employees. Unfortunately, that trust isn't always prudent. Bookkeepers — particularly those in small and midsize businesses — are ideally positioned to embezzle from their employers. And, in the face of expensive habits, mounting debt or other financial pressures, some of them give in to the temptation for fraud.

Less means more

When bookkeepers go bad, there are plenty of ways for them to steal without alerting owners to irregularities. One simple method is to include a "less cash" amount when depositing checks to the company account — an amount that goes directly into the bookkeeper's wallet. Another tactic is to open a sham account in the company's name with his or her name as signatory, and then deposit payments to the business in that account.

Outright forgery is possible, as well. Bookkeepers may forge an authorized signature on checks payable to themselves, or send fraudulent "letters of authority" to the company's bank. The letters give the bookkeeper unauthorized access to certain accounts.

Stop before it starts

One of the best ways to guard against bookkeeper fraud is to segregate duties as much as possible. Don't let your bookkeeper authorize, sign, post and reconcile checks while also handling every deposit. If there's no one else in your company to assume some of those duties, request that bank statements be mailed to your home. Then review them for anything unusual before you pass them to your bookkeeper.

You also may want to work with your bank to prevent "less cash" deposits or unauthorized new accounts, and to require verification of any "letter of authority" or other document that opens financial doors. And you might want to ask an outside financial expert to review your company's financial and bookkeeping records periodically or even outsource some of your basic accounting functions.

Signs of trouble

Above all, recognize that, given the right set of circumstances, anyone could be willing to commit fraud. Even the bookkeeper you've rightfully trusted for years may come under enough personal financial pressure to be tempted to steal.

Closely scrutinize your bookkeeper if he or she:

- Frequently takes work home or works late in the evening or on weekends,
- Is reluctant to take vacation time,
- Becomes defensive or resentful when questioned about records,
- Keeps disorganized books,
- Frequently misfiles deposit records, supplier correspondence and other important documents,
- Explains away tax delinquency notices as government error,
- Insists on handling activities such as picking up mail or liaising with financial contacts, or
- Suggests that you get rid of your outside accounting firm to save money.

None of the above is proof of fraud. There may be reasonable explanations for these and other potentially suspicious activities. But if they occur, don't ignore them. You may simply need to add more controls to your financial operations. If you're really suspicious, though, consider bringing in a forensic accountant to investigate.

Abuse of trust?

Bookkeepers occupy positions of trust in any company. If your bookkeeper no longer deserves your trust, it's better to know as soon as possible — before this employee has time to cause serious and lasting damage.

Fraud to watch for:

Hidden assets during divorce

Divorcing couples often find themselves facing significant financial details for the first time. Unfortunately, parties to divorce sometimes accuse their partners of hiding income or assets, and occasionally those accusations have some truth to them.

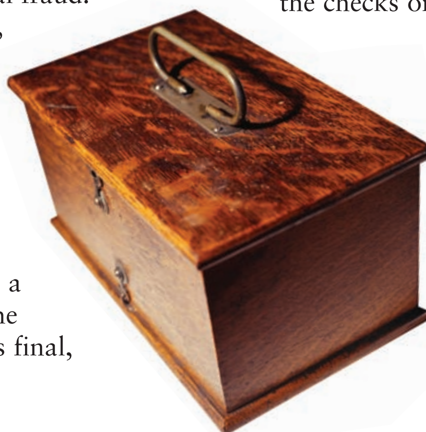
Failure to disclose income or assets may be explained by a simple lack of knowledge. A spouse may not realize, for example, that an executive benefit provided by his or her job is included in the marital estate. Or, driven by anger, mistrust and a desire to punish — emotions that surround many divorce actions — a spouse may deliberately choose not to disclose the existence of certain assets.

Clearing the fog

In either case, forensic accountants can help clear the fog and validate or disprove the divorcing parties' claims to disputed assets by using the same skills they employ in uncovering corporate financial fraud. And, as with corporate fraud, there are any number of creative ways for divorcing couples to distort their true financial pictures.

Spouses might, for example:

- Repay nonexistent debt to a friend, and then retrieve the money when the divorce is final,
- Keep cash in traveler's checks,
- Set up custodial accounts in the names of children, using the children's Social Security numbers,
- Hide funds in undisclosed whole life or universal life insurance policies,
- Overpay credit cards to make the balance available later,
- Delay business contracts or bonuses,
- Fail to reveal the existence of retirement accounts or stock options,
- Invest in certificate "bearer" bonds, or
- Undervalue art or antiques.



Spouses who are business owners have additional methods of hiding assets. They might, for example, pay "ghost" employees and then void the checks once the divorce is final.

Difficult, not impossible

These and a host of other attempts to conceal assets may be uncovered by experienced accountants — though it's not always easy. So experts trained in where to look are essential when there's the slightest question about the honesty of a divorcing party.

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An internationally recognized public speaker, Craig has lectured on topics involving fraud and its detection to auditors, investigators and attorneys. He is a faculty member of the Association of Certified Fraud Examiners and Institute of Internal Auditors.

Craig works as a consultant and expert witness for major corporations, law firms, law enforcement and governmental agencies on cases involving allegations of fraud and misrepresentation. Craig is frequently quoted in major newspapers and publications throughout the U.S.

McGOVERN & GREENE LLP

Certified Public Accountants & Consultants

Specialists in Fraud Examination and Litigation Services

If a business hasn't yet been a victim of fraud, it's been fortunate. According to the Association of Certified Fraud Examiners, fraud costs businesses in the United States billions of dollars every year. Small businesses are especially vulnerable because they often do not have controls in place to reduce the likelihood of fraud.

This is where McGovern & Greene LLP can help. Our firm specializes in helping corporations, attorneys, lenders, law enforcement and governmental agencies analyze financial records and contracts, identify and prevent fraud, recover and analyze evidence, and provide expert testimony in all of these matters. Our highly-experienced team of professionals includes certified fraud examiners and certified public accountants that are experts in the fields of fraud examination, forensic accounting, computer forensics, damage calculations, business valuations and audit services.

Our professionals can assist you in a wide range of matters, including:

- Fraud Examination
- Financial Investigations
- Forensic Accounting
- Asset Recovery
- Internal Audit Services
- Computer Forensics
- Training & Seminars
- Healthcare Audit
- Business Valuation
- Litigation Services
- Government Contracts
- Economic Damages
- Intellectual Property
- Contract Claims
- Construction Audits
- Electronic Discovery
- Profit Recovery
- Due Diligence

We welcome the opportunity to discuss your needs and answer any questions you might have about our fraud examination and litigation services.

Please contact us at 312.419.1961 or visit us at www.mcgoverngreene.com and let us know how we can be of assistance.

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