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STRATEGIES FOR TROUBLED SITUATIONS

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Is It Fraud or Incompetence?

A chain of home improvement centers consistently reported strong gross margins, but their physical inventory counts repeatedly showed horrific shrinkages (6 to 7 percent of sales), even as the company's loss prevention department and internal auditors implemented preventive and detective measures designed to find the source of suspected inventory theft. It was eventually discovered that clerks in the merchandise buying department, who did not understand the vagaries of retail accounting, were entering list prices into the accounting system instead of the company's actual selling prices, which resulted in grossly overstated book inventory figures.

A smaller retail company selling baby furniture also consistently reported strong gross margins and experienced major inventory shrinkages. The company's outside CPA firm attributed the inventory problems to accounting and procedural errors. When the company went bankrupt, it was discovered that the company's accounts payable clerk had been involved in a long-term embezzlement scheme. The CPA firm agreed to pay a large settlement in a malpractice case against it.

As these examples illustrate, the distinction between fraud and incompetence is often difficult to make. A cursory examination of a company's accounting records may reveal errors and inconsistencies that are common symptoms of both fraud and incompetence, including the following:

- Lack of a sufficient audit trail: unsupported balances or transactions, missing support or documents
- Transactions not recorded in a complete, timely, or proper manner
- Inconsistencies or significant unexplained items in account reconciliations, financial ratios or other performance measurements
- Missing inventory, cash, or other physical assets
- Unrecorded assets or liabilities, misstatements of revenues or expenses
- Commingling of personal and business assets and transactions or otherwise commingling assets that should have been kept separate

The distinction between fraud and incompetence can be especially difficult in small companies and start-ups. The typical entrepreneur has difficulty setting boundaries between his business and personal transactions, works an ungodly number of hours under tight financial constraints, and considers accounting to be something that you do once a year at tax time. When there are poor audit trails and misstated balances, evaluating whether there was fraud or incompetence can require deep analysis.

The following examples provide a couple of instructive case studies that illustrate how first appearances can often be misleading if not analyzed in context of the full situation:

Apparent Poor Business Management was Really Fraud in Anticipation of Divorce

When I began the valuation of a mortgage broker in a divorce case, I found that the owner of the business was very good at selling mortgages, but the company was barely profitable. On the surface, the situation appeared similar to many small businesses, in which the entrepreneur is fantastic at one thing (e.g., selling, production, or providing a service) but inexperienced and inept at other aspect of running the business. Indications of incompetence included sloppy record-keeping, poor controls, overspending, and loose operating procedures.

The engagement became more interesting when I noticed that certain expense ratios were out of line with the industry averages. Expenses for rent, telephone, office support, travel and entertainment, and other costs all seemed too high, based on the company's reported sales. It is not unusual for entrepreneurs to overspend on lavish offices, first-class travel, taking friends to lunch "on the business," etc. (I often say, only half joking, that my most comfortable engagements are insolvency cases, because people who are going broke are usually getting there by buying the best and biggest of everything.)

What was most suspicious in this company was the amount of commissions paid, something that even extravagant entrepreneurs don't

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tend to over-spend on.

The company paid its salesmen a percent of revenues, and the ratio of commissions to sales in this company (39 percent) was almost double the industry average of 20 percent. My interviews with a number of companies and salesmen in the same industry indicated that at that time the 20 percent commission rate in this industry was a fairly standard figure that didn't vary with sales volume, experience of the salesman, type of customer, transaction size, or any other variable. I called one of the company's salesmen, who confirmed that he was earning the standard commission rate of 20 percent.


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A reconciliation of the reported commissions to the company's payroll tax returns ruled out the theory that commission expenses were being overstated. The only way to account for this unusual ratio of commissions to sales was that either (a) revenue was understated or (b) expenses were overstated.

Also suspicious was the fact that the owner had not taken enough money out of the business to live on. This was at the beginning of the housing boom and those first movers in the industry were thriving. My neighbor owned a company in that same industry and seemed to be continually adding new wings on to his house. It didn't make sense that the company I was looking at was the money loser its tax returns purported it to be. I figured there had to be significant unrecorded revenues and/or payments to the owner.

I decided to focus on the sales cycle, to see if I could identify the revenue leak. The accounting detail showed an inordinately large number of refunds being issued that were evidenced by checks written that were recorded as negative sales. These checks broke down into two different categories: those that could be matched to a specific sale and those for whom no sales had been recorded.

Many refunds were easily traced to canceled sales transactions, since every sale was recorded individually in QuickBooks and identified the borrower's name. Revenue was recorded when the sale was made, and a refund check was issued when the sale was cancelled. Then there were other transactions that looked like refunds, but there was no corresponding sale originally made for those customers in the accounting records. Cancelled checks showed that the refund checks did in fact go to the payees that they were made out to, and had been deposited into too many different bank accounts than would be possible if the company was running a false refund scheme. The only implication of these refunds, therefore, was that the original sales that related to them had never been recorded.

Interestingly, when I added up three years of refund history and calculated the ratio of total refunds to refunds of identified customers, and multiplied that ratio by the reported sales, the result was a derived sales figure that was very close to the sales that would be needed to justify the commissions paid based on the standard industry rate.

For example assume that over three years there were $80,000 of refunds paid to customers, and only $40,000 of those could be traced to recorded sales. This would imply that possibly one half of the sales were not recorded. Further assume that the company's records indicated that 40 percent of the sales were paid out in commission, but industry practice and other information indicated that the normal commission rate was 20 percent. If based on the testing of refunds you inferred that the sales were actually double the amount reported, that would bring the commission ratio down from the unexplainable 40 percent to a much more reasonable 20 percent. Thus, both the unexplained refunds and the level of commissions paid seemed to indicate that actual sales were about two times higher than what was actually reported.

The evidence had become strong enough that sales were being skimmed out of this business to warrant further subpoenas of accounting detail.

The American Express bills for this company had been booked each month only in total, and always charged to travel and entertainment. Original copies of the bills were subpoenaed, and I found a large number of expenditures for flowers, jewelry, fine dining, hotels, and a few European getaways. None of these were related to the company's normal and ordinary business. The owners' wife had no knowledge of them.

It isn't unusual for business owners to have multiple bank accounts or to commingle business and personal assets. However, in this case none of the inferred missing sales were ever found being deposited in personal accounts or anywhere else.

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The American Express bills suggest the type of spending often seen with extramarital affairs. The fact that the owner was deceiving his wife established a pattern of deceit that could not only be inferred to business practices, but could provide a motive for it. Paying commissions and issuing refunds on sales that didn't seem to exist in the accounting records could be excused as accidental if it were only done occasionally, but a consistent recurrence of this in a business that was reporting losses each year could only be considered as willful.

This evidence of fraud (misrepresentation of material facts with intent to cause losses to both the spouse and the IRS) was instrumental in generating an acceptable settlement for the non-business spouse. For this client, it didn't matter that the missing money was never found — what mattered was establishing the pattern of intent to defraud. This evidence was used to lever a more favorable settlement for the wife.

Misleading Information Led to Material Losses, but There Was No Intent to Deceive

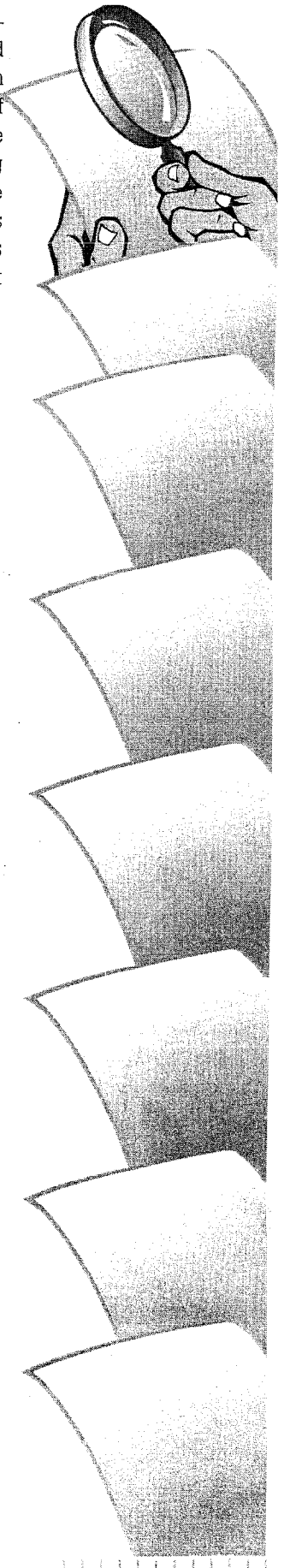
A forensic examination that I performed for the Department of Justice in a bankruptcy case, involving a franchisor, began with many indications of fraud. The financial statements were materially misstated when a $500,000 loan was accounted for as income. There was evidence of illegal check kiting, mishandling of trust funds, and commingling of business and personal interests to the detriment of both the franchisees and the company's lender. The company's accounting manager of the company purchased a very expensive car just days after two new franchisees made their new-franchise down payments and one week before the company filed for bankruptcy—which suggested the possibility of cash diversions. Adding further to these suspicions, the most successful franchisee in the chain had been the only one to receive all the latest equipment and technology and was also owned by the wife of the company's president. The franchisees and the banks looked at these facts and were sure that their money had been lost to intentional deception.

The president of the company had no formal business education, and his only business experience prior to co-founding this franchise was in managing a single convenience store. He had never taken an accounting or business course, but he supervised the company's accounting, administrative, and operational functions. He felt totally confident in running a 37-unit franchise based on his convenience store experience. This inexperienced and under-qualified manager was a great salesman who had convinced his bankers, his investors, his franchisees, and himself that he was capable of managing all aspects of a rapidly growing organization.

The material misstatement in the franchise offering involved a $500,000 loan that was characterized as income. The company had been in litigation with one of its vendors, and the matter was settled out of court with a $500,000 loan on favorable terms. The president referred to it as "income" when discussing the cash receipt with the outside auditors, because he expected it to be paid back with marketing funds to be received from new vendors the franchise was contracting with, not the company's money. If it wasn't income, he reasoned, his auditors should have told him. There had been many competing documents of different proposed settlements floating around, and the auditors had never received the signed copies with the correct final terms of transaction. The company's lawyer was an expert in franchise matters but had minimal accounting knowledge, and when she signed the attorney letter for the auditors she relied on what she thought was their classification of the transaction as income. The auditor, in turn, relied on the attorney's representation letter as evidence that the transaction was income, just as the president had described it. Everybody acted in ignorance and in reliance on the others. Had new franchisees not relied on the material misstatement that resulted from this, it could have been considered a comedy of errors.

The commingling of trust funds and the check kiting did occur. The franchisor had been struggling to keep up with its bills and debt payments for years, and had been staying afloat by selling new franchises and using the receipts from those to satisfy obligations to older franchisees. Every business plan ever generated by management showed that with just a few more franchise sales, cash flow would turn positive and all obligations to franchisees would be satisfied. Banks that were aware of the company's overdrafts believed these plans and loaned money based on them. Management's actions indicated that they sincerely believed in these faulty plans and continually tried to implement them. There was no evidence of cash being diverted out of the company for personal use, and the check kiting and trust fund commingling were done to help the company continue paying its bills. All of the cash that came into the company was recycled for what management considered to be the benefit of the franchisees and lenders. Management's intentions consistently seemed to be to keep the company afloat long enough to achieve a positive cash flow, not to intentionally defraud or transfer money out without receiving equivalent value.

The president's wife did own the most profitable franchise and did receive benefits of having the franchisor provide her with all the latest equipment and technology as a test site. She also tested equipment and technology that did not work well in the convenience store environment, causing her to incur additional costs and expenses. The debtor



had received value in learning which expenditures were worthwhile and which were not. There was commingling of resources such as labor and advertising between the franchisor and this one franchise that appeared to be tainted, but most likely would have appeared normal if the franchisor and franchisee had not been married. Again, there was value received by the franchisor by having its employees being trained in an actual franchisee environment. This store was the most profitable in the chain not because of the special favors it received, but because it had the best location, on a main road and directly across the state line from a state with much higher gas and cigarette taxes.

The purchase of the accounting manager's new car, which had inflamed everybody into yelling "fraud," was traced to funds that had been in her personal account for a long of time, a trade-in, and to a new car loan for the balance. None of the company's or creditor's money had been used to pay for the car.

Two factors convinced me that management was grossly incompetent and overly optimistic about their financial future (common among entrepreneurs), rather than malicious. First, there was a clear paper trail indicating that management intentionally kited checks to keep the company alive, but no trail at all indicating that management personally benefited from the scheme. Usually when they're trying to hide something fraudulent, they work much harder at obscuring all trails. When the trails are found, fraudulent management tries to make them look like something other than what they are, which did not happen in this case.

Second, from interviews I conducted with people in and outside of the company, I realized that the franchisees and attorneys who were alleging both fraud and fraudulent conveyance (the transfer of funds without the receipt of adequate value for the purpose of hindering creditors) had an incomplete set of facts. When more facts became available through my interviews and analysis of the accounting records, management's incompetence became more obvious. They had little understanding of financial concepts and believed that they could spend their way to prosperity. Some of their expenditures made no sense in the context of their financial situation, but in every case they received reasonably equivalent value. They alternately failed to react and over-reacted to signs of business decline, such as foreclosing on 15 struggling franchisees all in the same week. Other than corporate help for the president's wife's store, there was no trail of money flowing out either to management or to unexplained destinations.

In this case there were material misstatements of fact, people relied on those misstatements, and franchisees lost significant investments as a result of that reliance. What was missing, though, was any clear indication that the bad acts that specifically caused the franchisees' losses were intentional. After a voluminous presentation of evidence, the parties acknowledged that gross incompetence, rather than fraud, was at play.

"I'm Not a Crook, I'm Just Incompetent"

In many cases, fraudsters try to appear incompetent when they realize they are being investigated; they often claim to have limited knowledge of the situation, and blame themselves for being oblivious to whatever mistakes or schemes are taking place in their midst. True incompetents, on the other hand, have a tremendous fear of being judged as incompetent by others—or even admitting to themselves that they made catastrophic mistakes and misjudgments.

Fraudsters typically appear at ease when they are being investigated, because they either don't believe they'll be caught, or think appearing nervous will arouse suspicion. They are often glad to help you find the "real culprit" and will lead you all over the company trying to find who did it. Incompetents, in contrast, are often openly hostile to any investigation and take a "do what you have to and then leave" approach. They tend not to volunteer information and will answer questions as sparsely as possible. .

The following two cases I worked on recently illustrate the observation that honest managers are often unable to acknowledge their incompetence, while fraudsters want you to believe they are.

Incompetence

In one case, after 24 years of successful operations a business owner found that, for the first time ever, her bank line was maxed out and the company was not generating enough cash to make interest payments. She concluded somebody must be stealing lots of money from her. I performed an analytical review on seven years of historical performance, graphing trends of rolling averages of key metrics of the business. I noticed three sharp breaks downward in the trends during this period: The first broke an upward trend into a downward trend, and the other two greatly accelerated downward-trending slopes.

I asked the owner if anything unusual had happened in the three particular months in which the trends broke down. She answered that in the first she had had a mini-stroke, in the second she fired her long-term vice president, and in the third her son was hospitalized with major medical complications. I realized that it was not theft but periods

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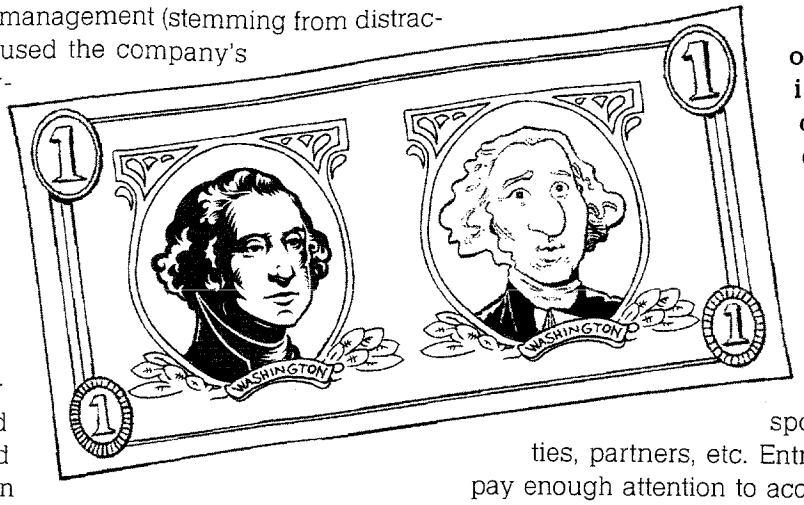
of negligent management (stemming from distraction) that caused the company's poor performance.



It was nearly impossible, though, to persuade the owner that her risk tolerance, her strength and stamina, and her interest in the business had all diminished, and that was the reason for the insolvency. She refused to discuss any possible impact from those three events, or even the events themselves. I ultimately convinced her that her employees were honest and that it was time to sell the company.

Fraud

On the other hand, at the beginning of another bankruptcy case I investigated, the owner of the company repeatedly insisted that he had no accounting or finance expertise, and was just a glorified salesman. He was very upset about how much money the creditors had lost and was willing to do anything I needed to help find where it had gone. He even suggested the places I should spend my time looking for the money. It turned out that he had a degree in finance and came from a family of financial planners. He had developed a sophisticated lapping scheme involving eight different bank accounts in multiple states. The evidence (including his initials on written instructions to the accounting department) clearly indicated a strong enough understanding of accounting to set up two sets of books and make one of them look like detailed support of the other. It also indicated fraudulent intent in the respective jurisdiction.

How to Tell the Difference

Being able to discern the difference between unintentional incompetence and malicious fraud requires the following talents and experience:

Extensive experience in working with both competent and incompetent accountants to understand the differences in their thought patterns. Fraudulent accountants will try to hide what they've done. Incompetent accountants will often try to hide what they don't know. Incompetents make errors in all kinds of accounts, while fraudsters tend to focus their activity in areas that are harder to verify such as cash transactions, off-books activity, or judgment accounts such as reserves, valuations, and opaque business purpose.

An understanding of the entrepreneurial mindset and the context in which it operates. Publicly held companies are more likely to overstate income and assets, privately held companies are more likely to hide income and assets from creditors, spouses, taxing authorities, partners, etc. Entrepreneurs often don't pay enough attention to accounting and can have systems that are sloppy enough to look fraudulent, which makes understanding the particular business owner's personality important in determining intent.

The business experience to identify relationships, procedures, or events that do not make sense. Examples of this would include the commissions and refunds discussed in case #1 above, lifestyles that cannot be supported on the amount of income a person is paid or reports on tax returns, excessive transactions with related companies, lack of an audit trail on what should be simple to account for transactions, and employees lacking the credentials and experience to satisfy their job descriptions.

Experience with small and mid-sized accounting systems to know where their weak points are, where their detection tools are, what types of mistakes users typically make with them, and how to coax useful information out of them. In QuickBooks, for example, using the "modify" feature on a report can disclose both the person who made an accounting entry and the exact date and time it was made, which can be very useful in determining whether an inaccurate accounting entry was a contemporaneous error or an after the fact cover-up.

The ability to spot patterns and inconsistencies. Incompetents are often uniformly incompetent, while fraudsters are often meticulous about every detail with one or two out-of-character exceptions such as missing just one vendor file or just a couple cancelled checks. Incompetents generally don't like to talk to investigators. Fraudsters will often talk in extensive detail about anything imaginable, but become inexplicably vague or uninformed when the area where the fraud occurred comes up.

Searching the accounting records is often just the start of a fraud investigation. To fully understand the situation, the investigator must become familiar with the context, the motives of the parties involved, and the evidence patterns to help determine if there was fraud or just a series of unfortunate blunders.

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