



## *Fraud Detection: Looking for smoke to indicate fire*

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**GUILTY!!** Those are the words that Ken Lay and Jeffrey Skilling heard on May 25, 2006 when the jury came back from deliberations of the fraud charges related to the bankruptcy of Enron Corporation. The problem is that many investors and credit providers did not see the financial troubles coming and continued to provide credit to the company and to invest in the stock until Enron filed for bankruptcy protection. Many of those same investors and credit providers were experienced professionals who should have been able to spot fraud and financial misrepresentations from a mile away. While some did (the ones that Lay and Skilling claimed ruined the company by publicly identifying the problems), many somehow did not.

As evidenced by the fallout from Enron and other similar cases, financial fraud and misrepresentations, if not detected, can cause significant losses for anyone connected with the perpetrating person or entity. So how does one detect fraudulent financials, or the potential for fraud, prior to entering a relationship? This question is not easy to answer. The first step is to understand some of the most common areas where misrepresentations and fraud occur, including:

- Overstating revenues
- Inappropriately capitalizing expenses, which overstates assets and earnings
- Understating cost of goods sold, which overstates inventory and profits
- Understating liabilities, which may also result in understated expenses
- Using reserves to manipulate earnings
- Related party transactions
- Diverting funds to other entities

The ability to detect fraud often depends upon the availability of information and the ability to perform adequate due diligence. In general, the more information that is available and the more research you do, the better chance you have at detecting financial misrepresentations. However, unless you own the company, have a court order or have other reasons to have access to company records, information is typically limited. Therefore, one must look for clues that potential problems may exist, or for “smoke” to indicate the potential for “fire.” We offer the following suggestions to help in that endeavor.

Guiding clients to financial success by providing the following services:

- Merger & Acquisition Advisory
- Financing & Capital Services
- Due Diligence
- Business Valuations
- Bankruptcy & Restructuring
- Litigation Services
- Fraud & Forensic Investigations

- ▶ ***Perform thorough financial analysis*** – This requires reviewing historical trends, analyzing financial ratios and comparing the subject company’s results to companies within the industry. The following are examples of trends that could raise red flags:
  - ✓ **Growth in accounts receivable relative to sales** – Accounts receivables relative to sales is often quantified by the number of days of receivables on hand relative to the most recent annual sales, or the accounts receivable balance divided by annual sales multiplied by 365 days. If this ratio increases or has been increasing over time, the reason for the increase may be legitimate, such as a change in billing policy; it could indicate credit issues with customers who owe accounts receivable; or it could indicate potential misrepresentations by the company due to early recognition of sales or recording fictitious sales. In addition to looking at the historical trends, the ratio should be compared to both industry averages and the company’s terms with customers to determine if there are potential problems.
  - ✓ **Growth in inventory relative to cost of goods sold and improved gross profit margins** – The ratio most commonly used in analyzing inventory growth is inventory turnover, or annual costs of good sold divided by inventory, which indicates how many times the company sells all of the inventory within a year. A declining ratio reflects a growing inventory balance relative to cost of goods sold. Inventory increasing while gross profits are improving could be legitimate, such as lower costs due to economies of scale and adding inventory to respond to expected growth. However, these trends could indicate the company is not properly expensing inventory, thus overstating gross profits and inventory. The turnover ratio should also be compared to industry averages.
  - ✓ **Cash flow significantly different from reported net income** – This can be measured by comparing net income to the operating cash flow less investing cash flow, often called free cash flow. Net income and free cash flow are virtually always different. However, if over time the cash flows remain significantly below net income and that difference grows, the subject company could potentially be overstating income. The key is to understand if the difference is for “real” business reasons or due to inappropriate business practices.

The challenge is to be able to identify the real problems, the “fire” so to speak. Ideally, you would have a chance to look at supporting documents for the financial information by performing extensive due diligence. However, your ability to request additional information is often limited. Furthermore, the company may not be performing one “big” misrepresentation, but a number of less obvious infractions that together represent a large issue.

- ▶ ***Read the footnotes to the financial statements*** – This might sound like something only an “accounting nerd” would do (you may want to dust off that pocket protector before this type of analysis is performed); however, the footnotes can be very revealing. Provided below are a few examples of red flags that could have been uncovered by analyzing the footnotes to the financial statements:

- Reading the footnotes to Enron’s financial statements would have brought to the analyst’s attention that a senior officer, who turned out to be Andy Fastow, Enron’s Chief Financial Officer, was also the general partner of entities that were entering transactions with Enron, a definite conflict. Those were the same entities that were hiding a significant amount of off-balance sheet debt and that Mr. Fastow used to basically steal a significant amount of money from Enron. While a lot of information was not disclosed regarding to these entities, Mr. Fastow’s relationship was disclosed.
- Herb Greenberg, a senior columnist at *MarketWatch*, wrote in the weekend edition of the *Wall Street Journal* for June 17 – 18, 2006: “The first clue a few years ago that Peregrine Systems was on its way to bankruptcy, landing fraud indictments for senior executives and being sold to Hewlett-Packard, was a shift in the way it recognized revenue.” Peregrine changed its method of revenue recognition from when the product was shipped to the customer to when the product was shipped to the distributor, which led to inflating revenues. The change in revenue recognition would have been reported in the footnotes.

In addition, the footnotes, if prepared correctly, can bring to light aggressive accounting policies, off-balance sheet liabilities and other information that may indicate issues that may potentially cause future problems.

In order to obtain the most value from reviewing the footnotes, the footnotes should be reviewed over time, noting any changes. When possible, they should be compared to those of similar companies in the industry, especially the accounting policies. In most cases, the footnotes alone will not reflect fraudulent activity, but can lead to questions to ask management.

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When reviewing financial information for publicly traded companies, make sure to look at all the related SEC filings, not just the annual report. Researching information on executive compensation, executive stock transactions, compliance with Sarbanes-Oxley and other areas disclosed in SEC filings can provide key insight into what is happening with the company.

- ▶ ***Do not assume anything; ask questions, sit back and listen*** – After you have performed your financial analysis and reviewed the footnotes, you should have a number of questions to ask management. The key is to ask the questions and to listen. I have often found that I have been shocked (and most often glad) by what someone admits when I’ve asked questions. There have been many times that I assumed one thing, and then I asked the “right” question (possibly by accident) and discovered a piece of information that significantly impacted my analysis. Other times, it is not what they say, but what they do or how they respond that provides valuable information. In the Enron case, one analyst asked a legitimate question, only to have Mr. Skilling get mad and call him an ---hole. (Note to self: if you ask a legitimate question and the person becomes

angry and calls you names, that may be a red flag.) The old sayings, “you do not know if you do not ask” and “actions speak louder than words” apply when meeting or talking with management.

This article is only intended to provide some of the key areas in which fraud and financial misrepresentations can potentially be detected. The problem is that typically it is not just in one area that misrepresentations occur, but a number of different areas that collectively represent fraud. The fact is that fraud and financial misrepresentation can and will occur, and even the most extensive financial analysis and research may not reveal fraud until it is too late. Furthermore, in the real world, it is often not practical to perform the amount of due diligence required to detect fraud. The key is to understand red flags that may indicate the potential for fraud and to perform the amount of due diligence that will mitigate the risk of potential fraud given the financial risks at stake. The old saying “where there is smoke, there is fire” can definitely apply when performing financial analysis.