

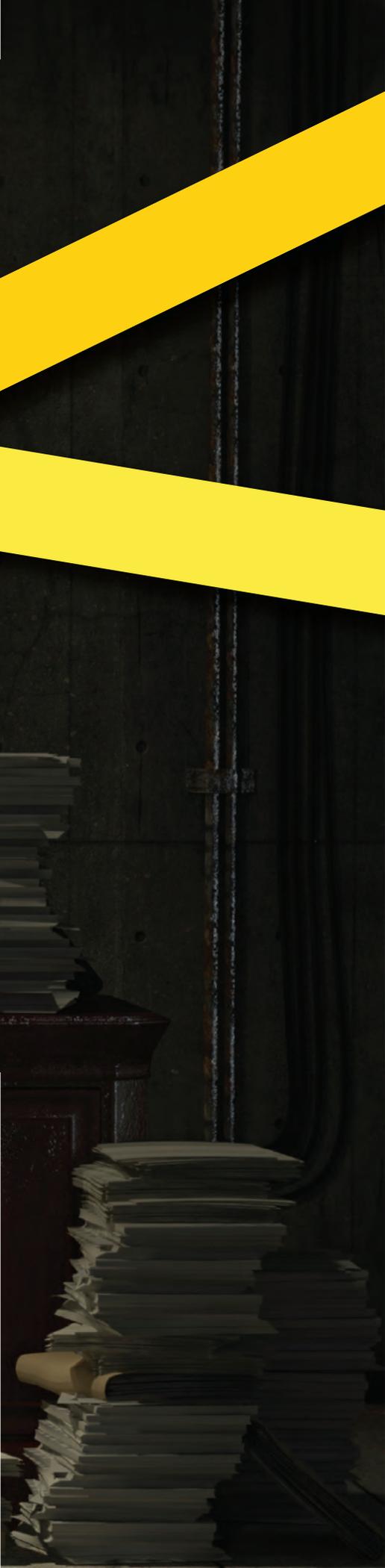
The Secured Lender

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MINIMIZING LENDER FRAUD LOSSES IN TODAY'S ECONOMY

By George S. Gerstein and Stephan M. Pinsky

When credit markets tighten, it is a sure bet that the frequency of lender fraud will rise. Without doubt, the amount of fraud detected during a recession increases because people become desperate.



Through the experiences of our consulting practice, working closely with financially troubled companies, and through numerous discussions with lenders, we have found that ABLs are more affected by fraud than commercial lenders. This, we believe, is due primarily to the relative weakness of borrowers' credit and the myriad of opportunities borrowers create by using fabricated information to gain access to additional funds.

Fraud committed against asset-based lenders (ABLs) occurs when borrowers intentionally misrepresent financial records, documents and statements to obtain money, assets or privileges from financial institutions. This type of fraud differs from fraud in other forms in that lender fraud indirectly enriches the perpetrator by misleading third parties (lenders, investors, owners, regulators, etc.) as to profitability, viability or the availability of funds under a borrowing-base agreement.

How Big a Problem Is Lender Fraud?

Some banks have reported that fraud occurs in up to 30% of their loans and represents 80% of their dollar losses. As stated in the Association of Certified Fraud Examiners report in 2008, (1) the median loss from financial statement fraud exceeds \$2 million. The median duration was 30 months (2). The report also indicates that most occupational fraud schemes are discovered by internal tips or by accident, even though 70% of victims utilized independent external audits of their financial statements at the time of the fraud. (3)

"Over half of the victims also had a formal code of conduct, an internal audit or fraud examination department, one or more employee support programs, as well as two controls mandated by the Sarbanes-Oxley Act: an external audit of the entity's internal controls over financial reporting and certification of the financial statements by management," the report explains. (1)

Lack of adequate internal controls and management overview were commonly cited as factors that allowed the fraud to occur. However, in many cases, the senior executive is the perpetrator. In those fraud cases, excessive organizational pressure to perform was the main cause cited and should be a particularly strong warning sign. Overall, the most

commonly cited behavioral red flags were individuals living beyond their apparent means or experiencing financial difficulties at the time of the fraud. (4)

Fraud Predictability

Various business conditions can motivate certain people to commit fraud. As the business climate started to turn sluggish after the housing downturn in 2007, for example, companies began to experience less demand for goods and services. Margins were squeezed due to higher prices for energy, commodities and other raw materials. Many saw these events as temporary and one of many normal swings in the business cycle. Pressure was still on to grow sales and inventories continued to build. Borrowing lines topped out and customer payments slowed, tightening the cash availability.

In 2008, demand in the manufacturing sector plunged. Real estate values, formerly used as collateral, collapsed and the credit marketplace was in turmoil. In the past, there were alternative sources of capital from traditional nonbank lenders. But this time that avenue was shut down due to the credit crisis.

Thus, most professionals should anticipate an increase in the number of lender fraud cases in 2009 due to the recent pressure on liquidity, which we expect will likely cause people to take questionable actions.

Why and How Does Lender Fraud Occur?

Desperate times call for desperate actions. For stressed borrowers, oftentimes an innocent or seeming immaterial fictitious transaction morphs into the altering or enhancing of financial statements for purposes of managing covenants or ratios. It becomes a pattern that expands so that borrowing availability continues to grow. Perhaps the invoice dates were changed or invoices that resulted from orders that were not shipped were included in the calculation of the borrowing base. Sometimes, fictitious invoices have been created. Now the company has bigger problems: it has committed lender fraud.

In a memorable, yet creatively simplistic example, a borrower recently attempted to manipulate company data using Excel spreadsheets. When asked why it took data from its ERP

and uploaded it into an Excel format before submitting it to the bank, it replied that doing so “dresses it up; makes it look prettier.” Upon examination of the data, we found that the company was changing invoice dates and adding other transactions to the Excel worksheet — almost 200 additional invoices and a few fictitious customers. As a result, the company overstated nearly \$10 million of eligible collateral for its borrowing base and had at least \$8 million of overstated earnings in the year.

Using Excel spreadsheets or financial report writers to produce financial reports is a red flag. This results in a lack of accounting controls and audit trails to ensure that the financial data is accurate, complete and reflects what’s actually in the company’s accounting system.

In our practice, we find it necessary to identify how the current systems and reporting applications operate in order to determine the reliability of the client-provided data. By comparing financial records from the database files in the borrower’s ERP system to the financial records the borrower actually produces, lenders can mitigate the opportunity to manipulate reports.

Creativity also surfaces when a company attempts to inflate its inventory. Accurate inventory-costing and movement-tracking is usually the most complex area for companies to integrate with their accounting systems and general ledgers. A nonintegrated inventory control system that requires an adjusting month-end journal entry leads to a lack of controls and an open invitation to mislead lenders.

What Loan Officers Need to Do in the Current Environment

The bad news is that fraud will continue to occur. The good news is that lenders can minimize it by recognizing the early warning signs and taking preventive ac-

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tion to minimize losses. The objective is to identify fraud as soon as possible and cut potential losses.

Here are steps you should take right now:

Many lenders have been increasing the frequency of their field audits and, in certain cases have been performing unannounced exams. We suggest expanding the scope of the field exams to include the impact that IT systems have on the bank report contents and presentation. This will require that field auditors focus on the source of the financial data and promptly follow up on questionable items or transactions.

Pay close attention to the clues. Apparent minor errors in reporting or open field audit items that remain unreconciled can be indicative of poor management controls or fraud.

Remember also that fraud can occur in industries that are faring well. What is consistent, however, is that unscrupulous people commit fraud, and they aren’t prompted by recessions alone. Thus, the enforcements put in place to fight fraud should not stop after the recession has passed.

In the real world, it is very difficult for lenders to stay personally close to their

customers. However, they should orchestrate a regular monitoring of financial statistics, phone and mail verification of receivables, physical inventories and appraisals.

If there is suspicion that borrower fraud may be occurring, time is of the essence. Fraud is a cover-up for a worsening situation. The only certainty is that the hole will get bigger. The key tool in reducing the cost of the fraud is quick action. **TSL**

Footnotes:

- ¹ 2008 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners Report, page 4.
- ² 2008 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners Report, page 17
- ³ 2008 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners Report, page 18
- ⁴ 2008 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners Report, page 65

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