

Don't let fraud derail your deal

You're days away from finalizing an acquisition that's expected to fuel significant growth for your company. But an anonymous tip and follow-up research reveals that your target's CFO was investigated and indicted for financial statement fraud while working for another company. The case never went to trial, but the charges — and lack of disclosure about them — naturally lead you to question what the business you plan to buy may be hiding. The deal, subsequently, is brought to a grinding halt.

A thorough investigation performed by forensic accounting and other financial experts during the due diligence stage could have helped prevent this unpleasant — and costly — end to the transaction. Before you waste valuable time and resources negotiating a deal, do your homework.

How well do you know your seller?

The majority of occupational fraud is perpetrated by rank-and-file workers and lower-level managers. But, as the Association of Certified Fraud Examiners has concluded repeatedly in its annual *Report to the Nation on Occupational Fraud & Abuse*, fraud committed by owners and executives is the most financially damaging and can, by extension, harm the value of your deal.



Even if a company has fraud policies and internal controls in place, owners and executives can override them. These individuals also have access to financial statements, as well as incentives — such as bonuses for exceeding certain growth targets, or to inflate the company selling price — to falsify them.

So, it's essential to perform background checks on, at the very least, your target's owners, CEO and CFO. A thorough check can uncover an executive's criminal past involving embezzlement, theft, forgery and other types of fraud, as well as involvement in civil litigation. It could also reveal that an individual has falsified items on his or her resumé and other pertinent personal claims.

What are some common schemes?

Management has myriad ways to artificially inflate its company's value, including:

Write-off techniques. The company might take large write-offs when profits are lower to make them appear even worse. This allows the company to reduce expenses and boost future earnings.

Numbers games. Companies might record sales early — and expenses late — to create the illusion of increased profits.

Vendor antics. A business might provide loans to major customers so that they can make large product purchases and give the appearance that the company's sales are booming.

Benefits roulette. A company could declare its pension plan overfunded by juggling proceeds and modifying items such as the interest rates and expected return on assets. The company can't legally remove money from the pension fund, but these tactics can reduce or eliminate its mandatory plan contributions.

Other schemes might involve hiding liabilities, misappropriating assets, overvaluing receivables and securities and overstating inventories.

What do experts look for?

Because fraud schemes can be complex and difficult to spot, a forensic accountant is a particularly useful addition to your due diligence team. These fraud experts use their accounting, auditing and investigative

skills to detect signs that your target is cooking the books. Red flags include:

- ❖ Increased accounts payable, combined with dropping or stagnant revenues,
- ❖ Excess inventory,
- ❖ Decreasing reserves against bad debt,
- ❖ A large number of account write-offs,
- ❖ Increased purchases from new vendors,
- ❖ The recent introduction of new methods of calculating revenues and expenses, and
- ❖ Excessive tax-driven earnings reductions.

Fraud experts don't only examine financial statements, but also look at business practices that might provide motives to perpetrate fraud and cultural conditions that enable fraud to thrive. For example, domineering and bullying owners and executives are more likely to feel entitled to break accounting rules and coerce employees to participate in such activities.

Similarly, businesses that offer financial incentives for employees to meet high, even unrealistic, sales growth numbers — particularly if employees are meeting them — merit a closer look. High employee turnover and worker, customer and vendor complaints are also strong indicators that something is amiss. Finally, if the seller tries to restrict your due diligence

A due diligence frame of mind

Even before you begin formal due diligence, conduct an initial assessment of how “fraud resistant” your target company is. For example, does the company appear to have effective governance and antifraud policies? What about defined and enforced codes of ethics and strong internal controls that are regularly reviewed and tested for compliance?

When companies have invested time in identifying and solving corporate governance and financial issues, it reduces the risk that those issues will emerge later. Depending on the industry, you may be able to review results from regulatory examinations to help identify potential weak spots early.

team's access to financial data or prevent them from speaking with key employees, be wary.

Too good to be true?

When buying a company, it pays to be skeptical — particularly if its earnings or selling price seems too good to be true. Keep in mind, however, that inaccurate financial statements may be a sign of incompetence or poor management, not an attempt to mislead potential buyers. A fraud expert can help you tell the difference and ensure that you make a well-informed decision. ■