

Market Liquidity Can Mask Fraud Threats

By Margaret M. Good and David R. Heilman

What market factors are making lenders more susceptible to fraud?

In the land of opportunity, the availability of new cash may possibly cause more problems for lenders than anticipated. The potential for corporate borrowers to venture into fraudulent practices seems to have increased in the recent era of abundant credit. It's important for lenders to be aware that maintaining rigorous underwriting standards will be key in protecting these investments.

Lending activity in 2006 hit a record high with leveraged loan volume of \$480 billion, up from \$295 billion in 2005. In addition, leverage multiples also increased, with Standard & Poor's (S&P) reporting middle-market leverage multiples of five times EBITDA ("earnings before interest, taxes, depreciation and amortization"), the highest level since the late 1990s. These statistics are clear indicators of the vast amount of liquidity in the marketplace and the aggressiveness of lenders in the leveraged arena.

One of the reasons for the increase in liquidity in the marketplace is the continued emergence of new lenders. New alternative sources of funds in the market continue to come on the scene. S&P reports that the number of investment vehicles has more than doubled since 2003, adding to the competitive pressure in the lending environment. Today, only 20 percent of leveraged loan volume is through banks, down from nearly 70 percent a decade ago.

Many more institutions are pursuing the available opportunities at the same time as traditional lenders are feeling increasing pressure to grow loan portfolios. And these nontraditional lenders are seeking

different vehicles through which to employ the enormous amounts of capital they have raised. This has resulted in financial institutions moving into industries they have previously avoided or don't understand and has led to a general relaxation of credit standards.

The increased liquidity in the market is pressuring lenders to move quickly to close on loan transactions, shortening the underwriting process, and has led to a loosening of underwriting standards. Less

restrictive, or nonexistent loan covenants; less rigorous underwriting processes; a heavier reliance on the due diligence of underwriters; late or less complete field audits; higher advance rates; and more lenient definitions

of eligible collateral are symptomatic of this competitive environment.

This situation has made lenders, traditional and nontraditional, more susceptible to fraud perpetuated by their borrowers. We examine several of these issues more closely:

- Lenders are lending into situations that they don't understand.
- We are in a "borrower's market."
- Don't rely on someone else's due diligence.
- Inventory—is it really there?

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- Accounts receivable—who sold what to whom?
- Capital expenditure funding—what happened to my equipment?
- Financial statements—look behind the scene.
- Management—whose side are they on?
- Affiliates—where did they come from?

Lenders Are Lending into Situations That They Don't Understand

We are increasingly seeing financial institutions entering into transactions that are outside of their knowledge base. The race to employ funds and grow portfolios to meet established targets results in lenders moving far too quickly into areas they do not fully understand. The Meridian Group has recently been involved in two situations where the lenders did not fully understand the revenue cycle of the business and how the accounts receivable reported on the borrowing base certificates were created. In one case, reported sales actually represented deferred revenue, subject to future performance by the borrower. In the second case, sales were reported at a gross number that was offset by significant commissions due to the agents that generated the business leading to the creation of the receivables. Not understanding the true nature of the revenue cycle of the businesses can result in significant collateral exposure for a lender. This is an opening that unscrupulous borrowers can exploit.

The Effect of a "Borrower's Market"

Until recently, the increased number of lenders and huge amount of capital available had made it far easier for borrowers to obtain credit than it was three years ago. Competition for available customers has led to a laxity in structuring debt facilities. We have seen numerous situations where lenders will adjust the secondary loan provisions that provide them with

critical protections. This is often the case in the area of financial covenants. "No covenant" loans have become prevalent to the point where there are no covenants so long as the borrower meets certain availability standards. This removes early warning signals and default triggers that provide lenders with important early opportunities to protect themselves. Without these pressure points being available to the lender, the borrower may dig itself into a deeper hole before being brought to task. In turn, this increases the pressure on the borrower to manipulate results or borrowing base certificates to delay the ultimate default.

The haste to get to the commitment stage with potential borrowers may result in the lender waiving or delaying until postclosing the field

audit requirement on secured transactions. This provides an opening for borrowers to misrepresent accounts receivable and inventory on the opening borrowing base certificate and to continue this pretense through-

out the relationship. To be more competitive on expenses, the lender may waive periodic audit requirements or do limited-scope audits that do not uncover the misrepresentation.

Don't Rely on Someone Else's Due Diligence

With more lenders competing for fewer transactions, participation in club deals has become a mechanical process with little due diligence. Although some frauds are extremely difficult to uncover, the more eyes looking at the information, the more likely it will be discovered. Little or no independent research is being conducted. In the Le-Nature's bankruptcy filed in the U.S. Bankruptcy Court for the Western District of Pennsylvania in November 2006, the debtor had reported revenue of \$275 million. The restructuring group brought in before the bankruptcy filing reported its estimate of revenue to stand at about \$32 million. It also reported that the company kept two different sets of books. There were more than \$750 million in bank debt, bond debt, lease obligations and other liabilities due from the company.

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The bank debt was syndicated in September 2006, with many of the lenders relying on the due diligence of the placement agent and others. This fraud may not have been easily detected, but the greater the number of underwriters examining the credit and the more intensive the underwriting process, the greater the likelihood that someone would have identified an issue leading to exposure of the fraud.

This is not only true for syndicated transactions. Investment bankers are placing debt facilities for private companies in a hypercompetitive environment. The pressure is on the lenders to provide rapid approvals or be left behind. This can lead to shortcuts in the due-diligence and underwriting processes that result in lenders missing warning signals of fraud or situations that will allow fraud to be perpetuated.

Inventory—Is It Really There?

One of the most obvious places to fabricate a borrowing base certificate is with inventory. Cases that we have seen recently run the gamut of misleading inventory figures and include the following:

- Inventory that has been deliberately miscounted
- Inventory that has been moved from location to location to improve the count
- Values that have been inputted incorrectly, altered or have had dating changed
- Obsolete inventory that is kept on the balance sheet to support borrowings
- Consigned inventory not reported as such

One of the larger retailing frauds perpetrated was by Phar-Mor, a discount drugstore chain that filed for bankruptcy in 1992. The company inflated the value of its inventory to improve financial results and deceived auditors by moving inventory into a location in advance of the auditor's arrival. It was able to accomplish this because management knew in advance the locations to be audited and was able to prepare the stores. It is estimated that lenders, investors and creditors lost more than \$1 billion as a result of this fraud.

Accounts Receivable— Who Sold What to Whom?

Common ways to misrepresent sales and accounts receivable are not always easily recognized. They can include the following:

- Consignment sales that are often not correctly reported on the financial statement.
- Gross sales can be accurate, but in certain industries (such as retail food), promotional credits are estimated. There can be wide swings between the estimate and what actually occurs. Meridian was involved in a situation where credits were not processed in a timely matter. Although the CFO knew that significant unprocessed credits existed, he continued to report the gross amount on the borrowing base certificate to keep availability open under the line of credit.
- Sales are deleted and rebooked to alter the accounts receivable aging reports and improve the level of eligible receivables.
- Nonexistent sales are recorded. Meridian once worked with a construction company that accrued a large success fee on a real estate transaction that was based on an oral agreement to pay the fee if the deal closed (which it never did). The account receivable that was created was included in the borrowing base certificate.
- Receivables are booked that are, in reality, subject to completion risk and exposed to significant offsets. Meridian worked with a company who booked a sale and a corresponding receivable upon the execution of a contract to provide services at corporate events. The payments to be made under these contracts were subject to completion of the events that would occur far into the future. The accounts receivable were included in the borrowing base.

A clear understanding of the nature of the business, its revenue cycle and a complete field audit with appropriate testing procedures make it more difficult for a borrower to misrepresent the character of its accounts receivable.

Capital Expenditure Funding—What Happened to My Equipment?

When equipment is financed by lenders, sometimes there is no inspection before funding. In some cases, the equipment may not have been delivered. Meridian once learned of a situation where a former employee of a large equipment lessee colluded with an equipment lease broker to prepare fraudulent

lease documents that, in turn, were funded against by a lender.

The former employee represented that he was still employed at the company and actually used conference rooms at his former employer to close the transactions. A simple inspection and verification of the specific equipment covered by the lease could have prevented this fraud.

In the Le-Nature's bankruptcy mentioned above, the house of cards crumbled when a lender checking on the progress of equipment being manufactured discovered the order had been canceled. It found that the progress payment funded to pay for the construction of a new manufacturing line had been returned to the debtor. The debtor had apparently prepared documents on the lender's letterhead to accomplish the transfer of funds. The situation may have continued undetected without the attempt at inspection by the lender.

Financial Statements— Look Behind the Scene

There are a number of questions a lender should ask as it begins its review of the financial statements provided by a borrower:

- Is the audit being done by a close friend of the company?
- Are the financial reports coming from the general ledger system or a separate system?
- Are linkages between the systems automatic or is there manual manipulation?
- Does the lender really understand the flow of information?
- Does the lender know who the gatekeeper is of the information?
- Are the financial statements provided in a timely manner?

Any manual manipulation of entries that could automatically be transferred from one system to another should lead to additional questions. If the gatekeeper of any of the information used to make accounting entries is not a member of the accounting staff or is the only employee with access to the information, warning flags should go up. One of the questions that should be feared the most by any auditor or underwriter is, "Why do you need that?" In a recent assignment, Meridian found that all

revenue information was developed from a system that did not link directly to the accounting system. The data used to develop the accounting entries was prepared manually by a nonaccounting employee and sent to the accounting group for booking. In the course of our investigation, we uncovered a number of revenue entries that were suspect.

An underwriter or field auditor should examine the detailed general ledger entries, make certain that he or she understands the reason for any past years' adjusting entries and get explanations of any adjusting entries to ensure that the subject company is not manipulating its results.

Quick answers to any questions, full access to data and personnel, automated processes and few adjusting entries are indicators that the financial statements portray the actual results of the business.

Management— Whose Side Are They on?

Lenders need to access and understand the actions, not the words, of those in charge of the company. They need to understand the underlying motivation of the managers providing them with information and understand the internal dynamics and relationships between various departments within the organization. They also need to develop a sense for the environment and culture within the organization. They should be asking the following questions:

- Does the company have an open environment, encouraging communication between departments? Creating silos that do not communicate with each other makes it easier to compartmentalize and hide fraud.
- Is there an atmosphere of intimidation or dictatorial leadership? This could be an indicator of hidden issues.
- Is management always making excuses, no matter how good the excuses sound? They could be hiding deeper issues.
- Do managers seem at odds with the accounting department? Is there a lot of turnover in the accounting department? This should set off warning bells in the mind of an inquisitive lender.
- Meridian has found that loyalty isn't always an issue, because managers committing fraud nor-

mally treat their employees very well. This leads to loyalty on the part of the rank and file and results in a lack of communication to the lender.

- Are managers reluctant to share information or to provide direct access to raw information coming from the company's systems? Access to raw data and the underlying data entry makes it difficult to hide fraudulent entries.

The motivation of management is extremely important. What is their stake in the ongoing relationship with the lender? Does the availability of debt result in the continuation of above-market salaries, lavish perquisites or distributions to the managers as shareholders? Often, these are the motivations for fraudulent actions on behalf of senior management.

Affiliates— Where Did They Come from?

Very closely aligned with questions about management are questions about affiliates. Affiliates may be in place for legal or tax reasons but could be set up to provide for the fraudulent transfer of funds or assets out of the company to benefit shareholders or management at the expense of the lender. The lender should examine the purpose behind any affiliates. Meridian has uncovered the following situations:

Affiliates can be used to transfer assets or profits out of the borrower into entities owned by the owners, a subset of the owners, the executive team or a combination of these groups. This is frequently the case with real estate leased by the company. Lenders should always examine any of these transactions to make certain that the terms are arm's length. Particular care should be taken with any affiliated entities formed after the lending relationship has been established. This could be an attempt to transfer valuable assets out of the business in advance of anticipated problems or to transfer profits out of the business to owners or executives to the detriment of the lenders.

Affiliate companies are set up specifically to channel sales out of the company. If an owner believes that the core business is on the decline, he or she may move the profitable operations out to protect his or her personal interests. Meridian was involved in a situation where a husband set up a business in his wife's name and transferred profitable sales to this business, leaving the core business with the unprofitable customers.

Meridian is currently investigating a circumstance where affiliates were established and placed between the ultimate customer and the company, in effect brokering sales and skimming profit off the top for the benefit of the affiliate. Accounts receivable were reported under the original customer's name but checks were channeled through the "broker."

Liquidity Can Mask Problems

In conclusion, the vast liquidity in the markets has disguised many of the problems that exist in borrowers today. Ready access to capital and replacement lenders gives borrowers the opportunity to replace existing lenders rapidly and easily, often with more lenient terms. This obscures many of the underlying issues with the business. Lenders with loans moving onto the watch list are finding a ready resale market, often to alternative lenders such as hedge funds. These loans are being sold at a relatively small discount, or in some cases at par, with little due diligence on behalf of the buyers. Borrowers are buying more time to mask their problems or to continue to perpetuate fraud.

In our conversations with lenders, we are hearing of an increasing number of situations where they have been the victims of fraud. So long as the pressures to grow the portfolio and relax terms and standards continue, we expect this trend to increase and, in fact, to accelerate. Only a return to rigorous underwriting standards and controls and quick reaction to early indications of problems will halt this trend.

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