

# Financial Statement Fraud and the Lending Decision

By James P. Martin and Harry Cendrowski

Frequently, clues are plainly visible long before fraud is discovered.

Commercial lending decisions are made under the premise that the loan customer has the ability to repay the debt. Oh sure, there are the unforeseen circumstances and unidentified risks that overcome the organization's ability to maintain their business plans and adhere to their repayment obligations, but generally, given a fair chance to evaluate the organization's business situation, the lender should be able to evaluate the repayment potential. At the same time, fraud is a very real threat to every organization's ability to repay its obligations, and it removes the chance of fair evaluation of the business situation. Given the increasing incident rate of fraud across all segments of business, it is no longer feasible to consider fraud an unidentified risk. Loan officers and financial institutions must consider the risk of fraud when evaluating financial statements and organizational operations for the purposes of making a lending decision.

Fraud can be broken down into two main categories: asset fraud and financial statement fraud. Asset fraud occurs when a perpetrator removes assets (typically cash) from the organization. Ideally, the organization has some sort of monitoring control in place to identify the actions of the perpetrator. Unfortunately, in many cases, the fraud is discovered when checks begin to bounce. Thus, it may be difficult or impossible for the organization to meet its loan repayment obligations. The perpetrator has stolen funds needed to repay the loan.

Financial statement fraud occurs when management creates fictional or erroneous entries to the financial statements with the intent to mislead the user of the financial statements. There are many different ways to accomplish this and many different rationalizations for such actions. Among the most telling: "If I don't make these entries and show a profit, I'll never get my loan renewed." Management has tilted the table through deception and created a situation where the bank could take a lending decision that, but for more accurate information, it would never take.

In addition to the two types of fraud, there is an overarching risk of financial distortion due to money laundering activities, either by the principals of an organization or as a service provided to third parties. Money laundering can make an organization appear to have increased sales and revenues, without any services actually being performed. Money laundering is a complex area of concern, beyond the scope of this article.

Fraud schemes can be quite complex, and perpetrators seem to demonstrate boundless creativity in developing schemes to mislead and quickly cover their tracks. Management of an organization has all

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the tools necessary to create fictional statements, but, fortunately for lenders, fraud schemes leave telltale signs, almost like latent fingerprints at a crime scene. With a little diligence and awareness, fraud can be detected and interpreted by the loan officer and other key personnel.

### What Is Fraud?

BLACK'S LAW DICTIONARY describes fraud as "the intentional use of deceit, a trick or some dishonest means to deprive another of his/her/its money, property or a legal right"; in other words, fraud involves intent, profit and misrepresentation. Financial statement fraud can conceal a sham organization or conceal an organization's inability to meet its repayment obligations. For a capital provider, be it a commercial lender, private equity source or equity market, a primary concern has always been distortions of financial position and results from misrepresentations in financial statements. Unfortunately, statistics maintained by law enforcement as well as the Association of Certified Fraud Examiners (ACFE) indicate that all types of fraud, including financial statement fraud, are increasing. The good news: A capital provider with an understanding of the causal factors as well as the warning signs of fraud can become better prepared to spot potential issues with financial statements and learn to make more informed decisions.

Distortions in the financial statements may be direct or indirect. In either case, the distortion can project a false image of the strength of the organization or hide severe operational and financial issues.

In a direct distortion, a perpetrator, typically management or an owner, makes unsubstantiated entries in the financial statements for the purpose of altering key financial indicators, such as asset values, revenues or expenses. The reward for this is often indirect: loans or capital based on strong asset values or revenues, increased salary for positive business performance, bonuses for meeting financial metrics. The perpetrator receives a legitimate reward based on falsely reported figures.

Indirect distortion occurs as a by-product of asset fraud. Asset fraud results in a direct reward to the perpetrator: He or she is removing cash or other valuable assets and needs to hide what has been done. Successful fraud requires concealment, and perpetrators must develop a means to hide the financial effects

of their actions; the entries to conceal the fraud can distort the financial statements. Imagine a case where a bookkeeper is writing checks to herself and cashing them. A credit entry will naturally be made to cash, but where can the debit entry be made to successfully hide it from management? In smaller frauds it might be possible to charge the debit to an expense account, as it might go unnoticed by management. For larger frauds, this might be possible too, if the perpetrator can identify an expense center that is not regularly monitored. For larger frauds, the perfect destination is a high-balance asset account that is not regularly reconciled or monitored or where the perpetrator also is responsible for reconciling the asset account. In either case, the debit entry to offset the unauthorized withdrawal will distort the financial statements and, unless involved in the fraud, management will likely be unaware of the distortion.

### The Required Elements of Fraud

The criminologist Donald R. Cressey proposed in the 1950s that three elements must be present in every situation where there is fraud; these elements have been interpreted by the American Institute of Certified Public Accountants (AICPA) for financial statement fraud as incentive or pressure, attitude and opportunity. Financial statement fraud involves an indirect reward; thus, the perpetrator has an incentive or is under pressure to misstate the financials. Attitude describes the attitude of the perpetrator for the need for accuracy in financial representations, and opportunity is the opportunity of the perpetrator to distort the financials.

Financial statement fraud is typically committed by senior members of the organization, including senior management and ownership. In most organizations, there is a built-in incentive or pressure to show positive operating results in the financial statements: salary levels, bonuses and perquisites are often based on the financial results reported by the organization. In addition, when the financial statements are used to support an application for financing or investment, positive financial statements will typically affect the amount, rate and covenant terms and conditions associated with the capital. It is important to remember when evaluating financial statements that management is not independent with respect to those financial statements.

Senior members of an organization have tremendous opportunity to affect the numbers in the financial statements. In every organization, management decisions and judgments directly affect account balances, including reserves, allowances and estimates. In addition, management can direct subordinates to make journal entries or override internal control procedures; management may even threaten or coerce employees into such actions. Given that management already has incentive to produce positive financial statements and opportunity to adjust the financial records, the actions taken by management will be determined by the third element: attitude.

Attitude describes the mind-set of managers as they perform their duties, including the calculation and recording of financial entries. Do recorded entries honestly reflect the economic substance of a transaction and represent management's true and best judgment, or are they mere building blocks meant to support a predetermined target? Attitude determines if management will take an extreme position with a transaction or maintain a commitment to fair presentation. Attitude also covers management's rationalization of why an inappropriate entry may actually be tolerable. For example, assume management is attempting to obtain a capital loan and management has represented stable revenue when, in actuality, it has declined over the past year. Management may rationalize that without the loan proceeds, the business may fail, resulting in employee layoffs and damage to managers' personal reputations; perhaps distorting actual sales a bit by recording sales activity that hasn't actually quite happened yet is a better alternative to the business failing. The loan proceeds are the incentive to distort, and management has assumed the attitude that the possible negatives associated with the distortion are preferable to the other outcomes. A proper management attitude is essential; for this reason, the capital provider needs to be concerned with the integrity of management and the control culture of the organi-

zation, as this is a primary driver of management's attitude toward accuracy in financial reporting.

Management's lack of independence, combined with the opportunity to directly manipulate the financial statements, drives the need to have an objective party perform an analysis and attestation on the financial statements. Fraud involves concealment; the perpetrator actively tries to hide his or her actions by creating misleading transactions, destroying documentation, creating fictional documentation or other nefarious means. The prospect of concealment means that even a properly planned and executed attestation engagement is not guaranteed to discover a fraud.

## Financial Statement Attestation

Certified public accountants perform attestation engagements on financial statements to provide

greater assurance that the numbers reflected in the financial statements are fairly represented. Not all attestation engagements are the same, however, and it is important to understand the type of attestation and the limitations of the work performed by a CPA under that engagement. The engagements naturally

become more expensive as the diligence applied in each type increases; often, the decision on engagement type involves balancing the risk mitigation of increased diligence against higher engagement costs.

Also, keep in mind that most certified public accountants do not have specialized training in fraud detection or investigation and may not be prepared to recognize the warning signs of fraud, should they exist.

## Tax Returns

Tax return preparation is not actually an attestation engagement; however, some capital providers receive tax returns as a surrogate financial statement. Sometimes, they assume that the preparer has performed a higher degree of analysis. Tax preparation

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software can print copies of the entire return on images of the forms and create a very presentable package. It is important to ensure that tax returns provided to the capital provider actually correspond to tax returns filed with the Internal Revenue Service (IRS). Tax return software also allows a user to easily create fictional returns that appear official. Tax returns are not required to be prepared by a CPA; even when one is, the CPA does not provide an opinion on the accuracy of the numbers or the underlying financial statements. If the client provides permission, the capital provider can obtain copies of the actual returns filed from the IRS; this permission could be included in loan covenants in certain situations when additional verification is needed.

### Compilation

Compiled financial statements look official because they are nicely formatted and accompanied by a letter from the CPA. As reflected in the AICPA standards, however, “[t]he accountant is not required to make inquiries or perform other procedures to verify, corroborate, or review information supplied by the entity” (AR 100.09). The accountant is required to note any information from other engagements that might call into question the financial statements, or the entity could provide financial information that on its face would cause the accountant to question the financials. The accountant, however, is not required to verify any of the numbers, and no opinion on the accuracy of the numbers is expressed. Thus, a compilation is not an attestation engagement either. A capital provider should be very cautious when decisions are based on compiled financial statements.

### Review

In a review, a CPA performs limited procedures to “obtain a basis for communicating whether he or she is aware of any material modifications that should be made to the financial statements for them to be in conformity with generally accepted accounting principles” (AR 100.23). In other words, the CPA expresses the limited assurance that he or she is not aware of any material modifications that should be made to the financial statements. A review does not include analysis of internal control procedures or any detailed

testing of transactions. It is important to remember that the limited procedures performed in a review engagement, including the lack of analysis of internal controls, mean that it would be extremely difficult for a CPA to detect fraud in the financial statements.

### Audit

Audit standards for public companies are defined by the Public Company Accounting Oversight Board (PCAOB); the AICPA defines standards for non-public companies. Standards for public and private companies are fairly consistent and compatible. Auditing standards require the CPA to “plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.” A CPA does not guarantee an absence of fraud in the financial statements; in fact, a CPA is not charged with actively looking for fraud in the course of the audit. According to standards, a CPA must consider where there is a risk of fraud based on his or her understanding of the business and alter audit procedures to consider that risk of fraud. The standards require that a CPA report any fraud that comes to his or her attention during the course of the audit to management, based on the procedures performed. During an audit, a CPA analyzes the company’s internal control system, tests detailed transactions, performs analytical procedures and performs verification and substantiation procedures (discussions with debtors, inventory tests, investment verification, *etc.*) to gain the described assurance. While audit procedures have been strengthened over the past several years through new auditing and oversight standards, it is important to remember that an audit is not infallible: Enron, WorldCom, Rite Aid and Tyco all issued financial statements that had been audited by a Big 5 accounting firm.

### Recommendations

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*Enron has built unique and, in our view, extraordinary franchises in several business units in very large markets.*

—Goldman Sachs analyst David Fleischer, *Is Enron Overpriced?* FORTUNE, Mar. 5, 2001, at 122.

No one really discovers “fraud.” Fraud is a complex legal issue that must be proven in a court of law. An investigation typically begins when someone discovers a warning sign that some impropriety could have occurred, commonly called a red flag, which would need to be investigated, documented and presented in a court of law to allow the trier of fact to rule on the issue of fraud. Since fraud involves concealment, a perpetrator is actively trying to hide the red flags from all parties, including the CPA and capital provider. The battle against fraud begins with an educated professional who can identify the red flags of fraud, understands what they potentially mean and applies the diligence to follow up on questionable items. Lamentably, fraud investigations frequently reveal clues and evidence of illicit actions that were plainly visible before the actions were discovered—if only those clues and evidence were noticed and pursued, the illicit actions could have been revealed much sooner.

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**1. Do not rely solely on financial statements.** Financial statements present a point-in-time summary of activity over a given interval. As the old saying goes, they are not an indicator of future performance. A capital provider should have an understanding of the client’s business, especially related to exactly how the organization creates value. This will allow the capital provider to independently evaluate the representations in the financial statements. Do the results make sense given the overall environment of the industry in which the organization operates? In addition, an understanding of the organization’s internal control procedures will provide an insight into the process in place both to create value and to ensure that financial entries accurately represent the results of the organization. Managers should be able to clearly demonstrate that they have appropriate control procedures given the industry and size of the organization. In certain circumstances, management or the capital provider may choose to hire an outside firm to document and evaluate the internal control structure. Management should be aware of the control structure and rapidly remediate any control weakness that is discovered.

**2. Pay attention to details.** We once worked with a small law firm that had suffered a major embezzlement by its controller; the embezzlement scheme lasted more than a decade. The plot was quite clever: The controller opened a personal line of credit at the same bank where the firm conducted all its business, drew on the line of credit and repaid the line with a check from the firm. No fictional vendor, no complicated lapping, just a single check per month payable to a bank that received a dozen or so checks per month anyway. The bank, however, needed legitimate income to support repayment of the line of credit, so the controller provided fictionalized tax returns. As the level of fraud grew, the controller

increased his personal credit line, which meant that he needed to show the bank higher legitimate income on the tax returns. Finally, a loan supervisor asked why the controller of a small law firm would be paid a salary of more than \$500,000 per year, as was represented on the

tax returns; this just didn’t make sense. Upon further review of the loan file, the bank found tax returns listing two separate social security numbers for the controller, a fact that had gone unnoticed for years. Unfortunately, in any organization, it is possible for people to lose sight of the important details that cross their desk on a daily basis—they begin to focus on processing a document rather than looking for nuances and anomalies. The details that go unnoticed are often indicators that something major is lurking beneath the surface.

**3. Follow up on unexpected or interesting items.** A bank had lost several million dollars in a wholesale floor plan fraud and wanted us to develop fraud awareness training for its loan officers. To develop the training, the bank offered one of the business owner’s personal financial statements that had been provided to the bank, in case there was anything of note that should be included in the training. The financial statements listed, among other things:

- Ownership interest in dealership: \$120,000
- Salary from dealership: \$60,000
- House: \$210,000
- Automobiles: \$850,000

Interestingly, the bank was unaware of the details behind the amount reported for automobiles, even though the financial statements had been reviewed by the bank as part of the loan underwriting process. This is not to say that the business owner did not actually own \$850,000 in automobiles, but that representation in the financial statements certainly raises several questions, given the amounts listed under salary and house. Is that one car or several? Where does he store them? How did he pay for them? Often, the answers to such follow-up questions do not satisfy the questioner and expand the mystery of the situation. The seemingly isolated anomaly is often a red flag of fraud—the perpetrator has worked hard to conceal his actions, except for one overlooked item. Of course, that is the time to continue to ask additional follow-up questions until you understand the true circumstances. In this case the bank already knew the story behind the numbers: The financial statements were selected because the bank had lost the amount extended in the line of credit.

This applies not only to representations on documents but also to other details. If you ask for a document that should be readily available, say, a financial statement for the period just ended, and it takes an extraordinary amount of time to produce that document, take note. The concern, of course, is that the extra time is needed to create or clean up the information before releasing it. Likewise, if asking for additional information or details raises a defensive attitude, your concern should rise as well.

**4. Maintain professional skepticism.** After working with a client or organization for a number of years, it is natural to achieve a sense of comfort with regard to documents and representations. Sometimes this means details that might otherwise raise concern are ignored. The 1992 adventures of John McNamara and General Motors Acceptance Corporation (GMAC) is a good example. During the course of this floor plan fraud, GMAC loaned McNamara more than \$5 billion on fictional van purchases and eventually lost \$436 million to the scheme. During the course of the scheme, McNamara was purportedly purchasing more than 17,000 vans per month for conversion and eventual export (through a closely related company). The scheme continued despite the fact that the volume of vans supposedly purchased exceeded the production of the entire industry, no one had ever seen the conver-

sion factory, and no vehicle ID numbers had ever been provided for any of the vans. Several credit analysts at GMAC raised concerns, but they were turned away by branch management, because McNamara was a good client who always paid on time; he had a long-standing relationship with the branch. The branch management eventually learned that no amount of history should override concerns about seemingly impossible representations.

**5. Require that explanations be rational, reasonable and verifiable.** Often, warning signs of fraud are discovered, only to be explained away by the perpetrator. Unfortunately, this provides additional time for the fraud to continue and further harm the organization. In one organization, fraud was finally revealed when checks started being returned for insufficient funds: The money had all been stolen. During the investigation it was revealed that the perpetrator/controller had continued to record the payroll tax expense and payroll tax liability, even though the money to pay the liability had been stolen. The payroll tax liability account showed an increasing balance over four years on the financial statements, eventually reaching approximately \$1.5 million. When this was discussed with the business owner, he acknowledged that he was aware of the liability, but the controller had explained that an “arrangement had been made with the state” to take care of the issue. While that answer opens even more questions to be explored, even if it were true, it does not explain why the balance originated in the first place.

**6. Remember: What do the financial statements say about the entity’s ability to pay?** At the end of the day, the financial statements should be a barometer for repayment of the account. Don’t lose the big picture in all the details in the financial statements. During a series of training workshops with a regional bank, one of the senior loan officers asked if the bank had a duty to report tax issues with a client to the IRS. It seems that during a recent loan review, it had come to the loan officer’s attention that a tax liability had not been satisfied and had continued to grow. In this case, the officer’s concern for the IRS had overshadowed the concern he should have had for the bank. If the entity is so cash-strapped that it is incurring a large liability to the IRS, it is unlikely that it will be able to repay its debt to the bank. In addition, if the IRS were to discover the liability, the bank debt would almost

certainly be subordinated to the IRS lien that could eventually be placed on the business. In any case, the likelihood of debt repayment is gloomy, and the bank should consider whether the account should be placed in workout.

## Conclusions

Keep in mind that the existence of one or more red flags does not necessarily mean that a fraud actually has occurred; the red flags are just possible warning signs. As the number of red flags begins to grow (for example, the controller with the really nice car can't get you the financial statements right away and is very defensive about it), the level of concern should grow as well, but red flags result from other causes. For example, if the financial statements cannot be produced in the expected amount of time, it may be that the accounting staff is disorganized or the bookkeeper is overworked or not qualified for the position. Such red flags can be ascribed to a "conspiracy of incompetence" that, while an interesting fact in its own right, does not reveal a fraud. Given the wide variety of causal events that can lead to a red flag, the capital provider should be careful in interpreting the underlying facts and not leap to any

conclusions or make accusatory statements while continuing to explore the situation.

Also, many organizations maintain separate and different sets of books for legitimate purposes. For example, an organization could maintain a cash basis set of books for tax purposes and an accrual basis set for financial reporting purposes. Companies with foreign operations may also need to maintain books according to the accounting standards in other countries. The existence of multiple books of entry does not necessarily mean there is a fraud, but it does demand that the requestor of financial information understand what he or she is receiving and why it is maintained by the organization. Again, it comes back to understanding the organization's business.

A relationship with an external expert in fraud investigation and forensic accounting can be invaluable to the capital provider. This resource can help interpret red flags, suggest possible follow-up actions, and, should the need arise, investigate the underlying transactions within the organization to determine what actually has happened. This relationship will typically pay for itself over time, as a single bad deal avoided will generate savings in excess of professional fees.

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