paBanker

The Official Magazine of the Pennsylvania Bankers Association

This Issue:

Bankers' Editorial Comments

Get Smart About Credit

Government Relations Update

New Legislation Changes Pennsylvania's Residential Mortgage Industry

Exploring New Horizons in Banking - Part 3

Direct Deposits of Social Security Payments with *Go Direct*

Volume 10.6 *November-December 2008*

paBanker
The Official Magazine of the Pennsylvania Bankers Association

Bringing timely news and information to the membership of the Pennsylvania Bankers Association

Featured Articles...

Government Relations Update ....Page 23-26
New Legislation Changes Pennsylvania's Residential Mortgage Industry .... Page 28-33
Will You Freak-Out or Hunker Down........................Page 41
Direct Deposit of Social Security Payments with *Go Direct* .... Page 43
Exploring New Horizons in Banking - Part 3 .... Page 44-46
Banking On Fraud: Tips to Determine if Your Client is 'Cooking the Books' .... Page 47-49
It Was the Best of Times, It Was the Worst of Times... The "Minsky Moment" Has Arrived .... Page 53-55
How to Capture Deposits During the "Is My Bank Safe?" Frenzy ....Page 57
Basel II Regulation ....Page 59

Special Features...

2008 Get Smart About Credit Day...................Page 18-19
2008 Lending Conference Wrap-Up ....Page 21
2008 Washington D.C. Visit ....Page 34-35
Bankers' Editorial Comments...........................Page 37-39
Executive Leadership Program Registration Form ....Page 66
2008 Wealth Management & Trust Conference Wrap-Up ....Page 61
Schedule of AIB™ Online Courses ....Page 63-65

In Every Issue...

Chairman's Ramblings... Page 6
From the CEO .... Page 7
Ten on 10... Page 10-13
Community News .... Page 15-17
Editor's Notes .... Page 22
PBA Services Corporation .... Page 69-71
PBA Calendar .... Page 73

Banking On Fraud: Tips to Determine if Your Client is 'Cooking the Books'

Lending decisions are made under the premise that the creditor has the ability to meet certain financial goals. Naturally, there are unforeseen circumstances and unidentified risks that can overcome an organization's ability to maintain its business plans and adhere to these expectations, but generally, given a fair chance to evaluate a creditor's business, bankers and lending institutions should be able to evaluate a creditor's earnings potential. At the same time, fraud is a very real threat to every organization's ability to meet its financial objectives, and it can diminish the likelihood of a fair evaluation of the creditor's financial well being.

Fraud is broken down into two main categories. The first category of fraud is asset fraud, where a perpetrator removes assets (typically cash) from the organization.

Given the increasing incident rate of fraud across all segments of business, it is no longer feasible to consider fraud an "unidentified risk." Furthermore, with the current economic conditions and resulting credit crisis banks must consider the possibility of misstated financial statements. Loan officers and their respective financial institutions must evaluate the risk of fraud when analyzing financial statements and organizational operations for the purposes of extending and maintaining credit.

Fraud is broken down into two main categories. The first category of fraud is asset fraud, where a perpetrator removes assets (typically cash) from the organization. Ideally, the organization has implemented monitoring controls that identify a perpetrator's actions, but unfortunately, in many cases, the fraud is only discovered when checks begin to bounce. Thus, it becomes increasingly difficult or even impossible for the organization to meet their loan repayment obligations. In essence, the perpetrator filches the funds needed to repay the loan.

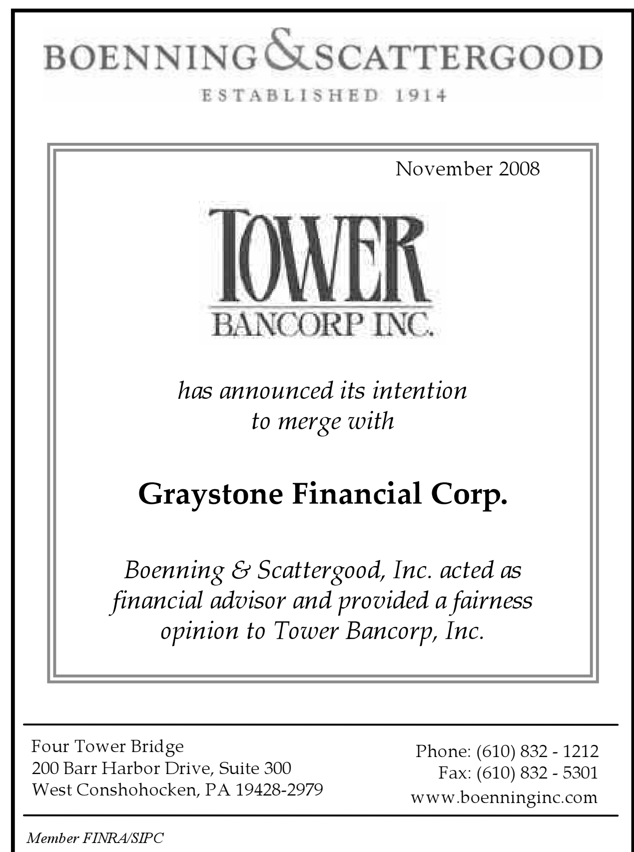
The second category of fraud is financial statement fraud. In this type of fraud, management creates fictional or erroneous entries to the financial statements to mislead users. There are many different ways to accomplish this, and many different rationalizations for such actions. Among the most telling: "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 extend credit that, but for more accurate information, it would have never extended.

Fraud schemes can be quite complex, and perpetrators seem to demonstrate boundless creativity in developing ploys to mislead and quickly cover their tracks. Organizational management has all the tools at their fingertips they need to be able to create fictional statements. But, not all hope is lost. Fortunately for lenders, fraud schemes leave telltale signs, akin to latent fingerprints at a crime scene, which with a little diligence and awareness can be detected and interpreted by lenders 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 maintain their repayment obligations. For a commercial lender, 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 professional organizations indicate that all types of fraud, including

– Continued on page 48



Continued from page 47

financial statement fraud, are increasing. The good news: a lender 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 understand how to make more informed credit 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 company ownership 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 levels 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: they are removing cash or other valuable assets, and they need to hide what they have 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. Often the perfect destination is a high-balance asset account that is not regularly reconciled or monitored, or where the perpetrator is also responsible for its reconciliation. The debit entry to offset the unauthorized withdrawal distorts the financial statements and unless they are involved, 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 AICPA for financial statement fraud as 1) incentive or pressure; 2) attitude; and 3) opportunity. Financial statement fraud involves an indirect reward; the perpetrator receives additional funds, 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.

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, and also why a sound understanding of the entity's internal control structure is essential. Fraud involves concealment — the perpetrator actively tries to hide their 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.

Recommendations

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 may 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 their CPA and banker. The battle against fraud begins with an educated professional who understands the red flags of fraud, what they potentially mean, and applies the diligence to follow-up on questionable items.

Do Not Rely Solely on Financial Statements

Financial statements present a point in time summary of activity over a given interval, they are not an indicator of future performance. A banker should have an understanding of their client's business, especially related to exactly how the organization creates value. This will allow the banker 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?

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 their loan officers. To develop the training the bank offered one of the business owners' 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 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 are they stored? How were they paid for? Often, the answers to such follow-up questions do not satisfy the question, and expands 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. This is the time to ask additional follow-up questions until the true circumstances are understood.

Many times, warning signs of fraud are discovered, only to be explained away by the perpetrator.

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. Bankers should remember that maintaining professional skepticism is often the best tool for detecting red flags, especially when working with familiar clients.

For example, 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 prior to releasing it. Likewise, if asking for additional information or details raises a defensive attitude, your skepticism should rise as well.

Explanations Should be Rational, Reasonable, and Verifiable.

Many times, 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 non-sufficient 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.

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. Additionally, 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 noted begins to grow, the level of concern should grow as well, but red flags can also be revealed for other reasons. For example, if the financial statements cannot be produced in the expected amount of time, it may only be because the accounting staff is disorganized or the bookkeeper is overworked, or maybe just 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, bankers should be careful in interpreting the underlying facts, and not leap to any conclusions or make accusatory statements while continuing to explore the situation.

A relationship with an external expert in fraud investigation and forensic accounting such as a Certified Forensic Financial Analyst (CFFA) from the National Association of Certified Valuation Analysts (NACVA) will also be invaluable to a banker. 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: a single bad deal avoided will generate savings far in excess of the professional fees.

About the Authors: *James P. Martin, CMA, CIA, CFE, CFFA and R. Austin Marks, CPA, CFF, CFFA are from Cendrowski Corporate Advisors, the leader in fraud deterrence. Web site: www.frauddeterrence.com. To contact them: (866) 717-1607.*