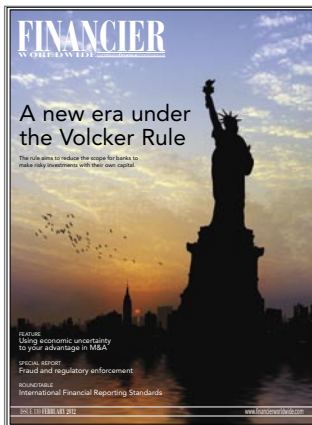


SPECIAL REPORT



FRAUD AND REGULATORY ENVIRONMENT



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Fraud and regulatory enforcement



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1STWEST FINANCIAL CORPORATION

SKADDEN, ARPS, SLATE, MEAGHER & FLOM (UK) LLP

Fraud and the regulatory environment

BY JERRY OLDHAM

If you are buying or financing a business, trust but verify – everything.

You don't know what you don't know... and you won't find out what you don't know if you don't perform the best possible due diligence on everything, without exception, always. If you legally and ethically perform the proper due diligence and investigations to verify what you have been told and what has been presented and represented to you, then a fraud can be avoided and the regulatory process and environment will not be a concern of yours. That said, you must obviously know the current regulations that apply to each category of due diligence being performed, or be certain that those performing it on your behalf do.

Unfortunately The Association of Certified Fraud Examiner's (ACFE's) 2012 Report to the Nations is not yet prepared, so the following statistics are based upon the 2010 Report to the Nations data compiled from a study of 1843 cases of occupational fraud that occurred in 106 nations between January 2008 and December 2009. All of the statistics presented in this discussion come from this resource document, which is worth referencing for its thorough presentation, statistics and findings. Any discussion of the current topic of fraud should be framed by the scope of the issue and its impact on the world economy, which this resource document provides.

The impact of occupational fraud. According to the report, the typical organisation loses 5 percent of its annual revenue to fraud. Applied to the 2009 Gross World Product, this statistic translates to a potential global fraud loss of more than \$2.9 trillion. The median loss caused by occupational fraud is \$160,000; however, nearly one-quarter of all frauds involve losses of at least \$1m. Small organisations are disproportionately victimised by occupational fraud. These organisations are typically lacking in anti-fraud controls compared to their larger counterparts.

Fraud detection. Frauds last a median of 18 months before being detected. Occupational frauds are much more likely to be detected by a tip than any other means. This finding is consistent since 2002 when the ACFE began tracking data on fraud detection methods. Anti-fraud controls appear to help reduce the cost and duration of occupational fraud schemes.

Perpetrators of fraud. High level perpetrators cause the greatest damage to their organisations. Frauds committed by owners/executives were more than three times as costly as

frauds committed by managers, and more than nine times as costly as employee frauds. Executive level frauds also take much longer to detect. More than 80 percent of the frauds are committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service or purchasing. More than 85 percent of fraudsters have never been previously charged or convicted for a fraud-related offence. This finding is consistent with ACFE prior studies. Fraud perpetrators often display signs that they are engaging in illicit activity. The most common behavioural red flags displayed by the perpetrators are living beyond their means (43 percent of cases) and experiencing financial difficulties (36 percent of cases).

Additional facts and findings. Occupational fraud is a global problem. Fraud reporting mechanisms are a critical component of an effective prevention and detection system. Organisations should implement hotlines to receive tips from both internal and external sources. Organisations tend to over-rely on audits. Although clearly important, they should not be relied upon exclusively to detect fraud. Employee education is the foundation of preventing and detecting fraud. Surprise audits are an effective, yet under-utilised, tool in the fight against fraud. Asset misappropriation schemes are the most common form of fraud by a wide margin, representing 90 percent of cases. Financial statement fraud schemes represented only 5 percent of the schemes, but caused a median loss of more than \$4m – by far the most costly category. The industries most commonly victimised are banking/financial services, manufacturing and government/public administration sectors. Given the high costs of occupational fraud, effective fraud prevention measures are critical.

The above statistics and findings, some surprising and some not, certainly frame the fraud issue. But as a provider of debt or equity capital to businesses, how do these findings affect the daily work of lenders, private equity firms, mezzanine finance firms and intermediaries? The findings that may either reinforce our certain predispositions or surprise us should also assist in framing the importance of performing extensive due diligence before the making of a significant loan or investment.

The statistics and findings that most impact a lender's/investor's perspective about detecting fraud include the following. Frauds by owners/executives are three times more costly than those perpetrated by managers and near-

ly nine times as costly as those committed by employees. Asset misappropriation schemes are the most common form of fraud by a wide margin of 90 percent. Financial statement fraud schemes represent only 5 percent of all schemes, but an average median loss of more than \$4m. Fraud is a global problem. More than 85 percent of the fraudsters have never previously been accused or convicted of committing a fraud, and, once discovered and proven, they are first time offenders. Small organisations are disproportionately victimised by fraud. More frauds are detected by tips than any other method. The typical organisation loses 5 percent of its revenue annually to fraud. Fraud perpetrators often display signs that they are engaging in illicit activities in the form of lifestyle or financial distress. Surprise audits are an effective, yet under-utilised, tool in the fight against fraud. The industries most commonly victimised by fraud are banking/financial services, manufacturing and government/public information sectors.

So, banks and financial service businesses are among the most common fraud victims. And detecting the fraud is most difficult, as evidenced by the fact that most frauds are detected by tips, in spite of all the other formatted and routinely practiced anti-fraud detection methods. For lenders and investors this is very disconcerting, considering the fact that their independent due diligence is essentially a 'snap shot' of several fraud investigations techniques.

The best take away from performing this independent due diligence is that prospective lenders and investors can be, and usually truly are, an independently interested third party and, therefore, not tied to a prospect's internal fraud prevention protocol. Although certainly interested in making a specific business loan or investment, and maybe somewhat predisposed based upon extensive preliminary interviews and research, lenders and investors can afford to be completely independent in their research, due diligence and investigations prior to making a final commitment to loan or invest. With proper notice, consent and releases and authorisations by the subject companies, owners and managers, banking, accounting and other privacy regulations will not get in the way of proper and prudent due diligence. While not a surprise to the prospective borrower or seller, an audit or field exam by a reputable accounting firm or an independent asset investigation and appraisal may be a surprise to the specific perpetrator of a fraud ►

in motion. Also, and in fact, regarding the performance of background investigations on key members of the ownership or management team, there are now US banking regulations that require a Know Your Customer (KYC) policy and a certain level of background investigation. A few short years ago there were no insurance requirements or federal statutes that required a state or national bank or federally chartered savings and loan institution to check a list for terrorists, narcotics traffickers

or those engaged in the proliferation of weapons of mass destruction. The FDIC and the FSLIC changed all of that in 2003 with new KYC regulations subsequent to the passing of the USA Patriot Act of 2001.

The conclusion with regard to fraud is that it is global and can be detected, but not by casual means, and lenders and investors can, and should, take an independent due diligence look at prospective candidates and their management teams, using proven techniques and

investigations firms to underwrite a loan or investment.

A trust but verify case study: In a recent case, the CEO of a lender's prospect company was found to be incarcerated pending criminal charges for attempting to bribe his current lender. We discovered this fact while the lender's senior management were conducting interviews at the prospective borrower's place of business. They were told by the CFO that the CEO was having eye surgery that day. ■



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Jerry Oldham has an extensive background investigations and corporate due diligence background and a broad senior management resume in commercial banking, and corporate and real estate finance. He frequently serves as a consultant or expert witness in litigation and settlement negotiations involving complex corporate finance, real estate, banking, and lending practice issues, having assisted in the settlement of hundreds of lawsuits.

ORGANISATION GLOSSARY



1stWEST Financial Corporation provides background investigations, asset searches and fraud investigations internationally for the corporate finance industry and other professionals in need of satisfying their background due diligence requirements on prospect companies, principals, senior managers, partners and key management personnel. Founded in 1991, 1stWEST provides information to assist our clients in investment due diligence and underwriting, contract negotiations, litigation resolution and pre-employment requirements by providing information to determine the financial character and capacity of the business or person with which they are dealing or employing.

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