abfJournal

a Monthly Publication Dedicated
to the Asset-Based Lending Industry

The Dreaded "CEO" Trap

By Armand Lucarelli, CPA, CTP

Many loan officers aspire to be CEOs. Unfortunately, many loan officers also face the less appetizing CEO, "Career Ending Opportunity" when a credit goes bad due to fraud. This article is designed to describe some prudent steps that loan officers can take to avoid the feared CEO trap. The following case study illustrates a CEO trap:

Situation:

Young fashion house sold high end clothing to major department stores throughout the United States. The company had been reporting rapid growth, strong earnings, and was running out of cash. The company had engaged an interim CFO at the recommendation of their loan officer.

Action Plan

Several board members who were investors requested that we review the situation. Our review of the company revealed the following:

Late arriving merchandise from South America and Hong Kong was shipped and billed only to be returned. The company did not issue debit memos and left the uncollectible accounts receivable on the books. Further, it included the returned merchandise in its inventory; and the auditor took liberties with GAAP, making for some very creative financial statements. As the accounts receivable aged they became ineligible collateral, creating a cash crisis.

Our report to the Board of Directors indicated that assets had been overstated by over $3 million. What made matters worse was that the president was selling merchandise out the back door for cash.

Results:

The investors did not provide additional funds, and the loan officer had a "CEO" trap on his hands. Ultimately, the brand was sold; and the lender took a significant haircut.

The SEC and government agencies+ are coming down on companies that managing earnings and committing fraud. The problems do not stop with large companies trying to smooth out earnings, but covers the spectrum of companies both large and small. The problem becomes not just smoothing earnings, but in creating fictitious financial records others rely on to invest, lend, or extend credit.

Fraud is robbery without a gun and is only limited by the perpetrator's imagination. Enron, WorldCom, Merck, Global Crossings and Lernout & Hauspie are all old news today. Executives have and will continue to go to jail while investors have lost billions of dollars. These events are in the news. What is not in the news are the proliferation of frauds committed by middle market companies stealing millions from banks, creditors and investors. Right now, an employee, probably in upper management, is cooking the books. Don't let it cost you!

Typically, the employee does not start out to be dishonest. They increase inventory on a monthly financial statement, or borrowing base, pre-bill a customer for merchandise to report increased sales / profits, or increase the borrowing base. It is just a little, because next month will be a better month. Well, next month comes and it is not a better month and so goes the battle. Over time, what started as a little advance billing becomes fraud.

This happens for the most part because the CEO or a manager wants to pretend that the trend lines are smooth and on target. Never deliver bad news; it is bad for your career. The dollars involved in options, bonuses, lifestyle, and other compensation exert extreme pressure on today's managers. Those that have a little accounting knowledge think it is okay to paint with a little more gray to the point that it is no longer gray but fraud. Wall Street and lenders have accepted managed earnings during the good times, but will they know when the company's profitability turns into significant losses? Absolutely not!

The client always likes to whisper into the banker's ear how conservative they were in the reserve computations but somehow forgets to inform outsiders when they reduce those reserves or when they are gone. Once those reserves are gone the company turns to trickery to show profits which over time turns into fraud.

Areas in Which Fraud Occurs

Improper revenue recognition can start out as legally cutting deals with customers and billing substantial revenue as the period draws to a close. Legally, this is not a problem but it deprives the company of critical revenues and the associated margins in future periods. This will put additional pressure on future periods. Customers will learn the trends and wait until late in the month or quarter for the good deals before ordering, further eroding future profit margins. What follows is not only cutting deals at month end but keeping the books open a few days, then a week and in some cases longer to meet the numbers.

Bill and hold is also a concern. This trickery creates a bigger problem if it is included in the month end inventory. Consignment sales are not sales under GAAP. Software contract recognition is a problematic area with management using side letters and other gimmicks to record sales. Large collateral increases as a period draws to a close require close monitoring and possible auditing.

The old "hold those invoices in the draw" or tell your supplier to hold the invoice until next month occurs frequently. Another favorite place to hide expenses is in prepaid / deferred assets. It is amazing, the reasoning senior management will use to defer a cost – it will always benefit a future period. WorldCom (now MCI) is the poster child for this abuse.

As you can see, unethical people will go to any length to deliver good news. The lengths to which they will go are only limited by their imagination and a propensity to misrepresent the facts. The "keeper of the books" needs to feed his family and often acquiesces to the CEO's wishes.

The impact of Sarbanes-Oxley:

The Sarbanes-Oxley bill outlines a number of reforms for SEC reporting companies with incarceration as a potential penalty for offending officers. In the future, the CEO can go to jail for managing earnings – which many CEOs feel is their job. The list of those going to trial is growing from Koslowski at Tyco to Sullivan at WorldCom, to a long list at Enron. What about those running closely held companies not regulated by the SEC rules? Only time will tell if Sarbanes-Oxley will impact them.

Sarbanes Oxley is supposed to deter the liberal use of accounting rules and limit the use of cookie jar reserves. In the fall of 2003, I was a panelist at a CFO Summit. A previous panel consisting of well known CFOs was discussing analysts and earnings reporting. The subject of missing earnings was brought up. What upset several of us was the clear indication that, yes, cookie jar reserves continue to be prevalent. "If a company missed its quarterly numbers by one cent then they probably missed them by seven cents."

Use of a Turnaround Consultant

The selection of a turnaround consultant or other professional to assist in your time of need is important. Ethics plays an important part as does the 'consultants ability to provide the required services. Check the consultant out carefully. The courts have shown to not take kindly to a turnaround consultant who partakes in financial shenanigans. The turnaround consultant on the Mini Scribe case received a three year prison term.

Avoiding the CEO Trap

Investors and bankers should watch for red flags. With 45% of fraud cases involving founder CEOs with a large stake in the company the CEO's business ethics must be analyzed. Before lending or investing in a business where the founder is the CEO, insist on a strong outside board of directors. A strong outside board with financial professionals as part of the mix will not totally insulate the lender or investor from fraud, but it will go a long way toward achieving that objective.

The fact that 72% of the CEOs are involved in discovered frauds is critical. To assist your client companies you should strongly suggest that they institute the following strategies:

- Strong independent outside board
- Board/Executive Committee's that truly oversees the CEO
- Strong control environment
- Strong CFO
- A board that truly understands long range planning and that smooth quarterly increases in revenues and profits are not always possible

The best way to avoid fraud is the oldest adage in banking: "Know Thy Customer!" Controls are critical, so are ethics. Know whether the CEO is under sever pressure to maintain a lifestyle, maintain earning targets, or report only good news. Know the industry including current trends. If you are concerned, get a qualified expert involved early. You can avoid the feared "CEO" trap.

Armand Lucarelli, CPA, CTP is the founder of Capital Restoration LLC a leading Corporate Renewal Firm.

Reprint from the abfJournal volume 2 number 1