

Know the Risks and Warning Signs

FRAUD

BY WILL TEFFT

FRAUD IS A CONCERN IN EVERY INDUSTRY. According to a report released last year by the Committee of Sponsoring Organizations of the Treadway Commission (COSO),¹ most financial statement fraud is committed by smaller corporations with less than \$100 million in true assets and revenues. According to COSO, the typical fraudulent financial reporting scheme involves overstatement of revenues and assets for an average time of two-and-a-half years. About 95% of all fraud crimes are committed by senior executives, such as the CEO or CFO.

The COSO information correlates with publicized cases of equipment leasing fraud. In each instance, the company's real revenues and assets were far less than \$100 million. The revenues also were overstated, while liabilities—specifically lease and loan obligations—were understated or not disclosed. As in other industries, most frauds in the equipment finance market were committed by CEOs and/or CFOs who had accounting backgrounds and a sophisticated understanding of financial statement preparation and analysis.

Fortunately, fraud is a rare phenomenon in our business. Fraudulent transactions account for just one-fifteenth of 1% of the \$521 billion of equipment-related financing that ELFA members provide clients each year. But even that small percentage is still hundreds of millions of dollars. Lessors may avoid becoming a victim of fraud by knowing more about its typical perpetrators, risks and warning signs.

FRAUD PROFILES AND TYPES

Fraud cases generally fit a certain profile in terms of ticket size, credit-worthiness, revenue and type of origination. Historically, large-ticket financing with investment grade-rated credit has the lowest incidence of fraud. Conversely, small-ticket financing for companies with a middle-market/small-business credit profile has the highest incidence. In addition, the direct origination model generally experiences less fraud than broker-originated deals.

For a company to commit fraud in our industry, it must be a legitimate business that produces real goods or services. Most important, it has to have a seemingly credible set of financial statements to obtain

financing. Equipment fraud usually involves some iteration of two basic deceptive practices—either serial number fraud or deliberate misrepresentation of price or value.

Serial number fraud involves the receipt and subsequent financing of a fictional serial number for the purpose of financing the same “physical” item of equipment with multiple lessors. This is often done using false, fabricated serial number tags. The perpetrators are betting that the equipment will not be inspected and that any UCC filing searches will not show multiple filings on the same serial number. This fraud typically is committed at a “market” price to avoid any diligence or suspicion based on price.

Serial number fraud may be detected by comparing the “documented” serial number to the results of a physical inspection. This inspection also should confirm that the serial number plate is “original” from the factory, affixed in its original manner and unaltered. Inspections that simply validate information provided by the lessee, such as a photograph, may not detect tampering or alteration. However, a photograph combined with a telephone call to a legitimate manufacturer will validate the serial numbers with respect to the actual number, year of manufacture and, in some cases, the current owner/location of the equipment.

The second type of fraud—misrepresentation of price—is more subtle and consequently more difficult to detect. In these cases, the equipment actually exists and has a legitimate and verifiable serial number. However, the purchase price or appraised value does not reflect a true arm's length, market-driven price. The intent is to mislead the lessor with documentation, such as an overstated appraisal for a sale-leaseback transaction or inflated quotes and invoices. This type of fraud preys on

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lessors' relative inexperience with a specific type of equipment or their failure to properly conduct diligence around price.

Misrepresentation of price is most successful when the financing is for unusual or uncommon equipment types of which the lender has no prior experience and no secondary market data exists. It is virtually impossible to perpetrate this type of fraud for the “bread and butter” assets (e.g., construction equipment, transportation equipment, material handling equipment or common machine tools) given the abundance of readily available auction, sale and advertised price data. Often this approach to fraud may include significant installation, engineering, support and maintenance costs because most general equipment lessors will not know if these are valid unless they have specific expertise in the equipment.

RED FLAGS

Although it's relatively easy for fraud schemers to deceive credit analysts, equipment management professionals have a fail-safe approach to universal fraud detection that requires the competent performance of only two actions:

- Validating the purchase price with a subject matter expert
- Inspecting the equipment to validate its existence and serial number

For most transactions—and at most institutions—money is not available for inspections. In addition, most equipment professionals are not subject matter experts for all equipment types. From a more practical perspective, the key challenge is to first identify the higher-risk transactions that require further diligence.

What are the common red flags associated with fraud that should lead to further review? Here is a partial list:

- Request to fund against pro forma invoices
- Absence of line item or per unit pricing on invoices
- Absence of serial numbers on invoices
- Transactions for used equipment
- Unknown or unfamiliar manufacturer, dealer or equipment type

- Restricted flow of information, including inability to speak with vendor or customer
- Appraisal included with submission does not comply with the Uniform Standards of Professional Appraisal Practice and is from a regional or local appraiser who lacks subject matter expertise and/or credentials from the American Society of Appraisers
- Poor quality documents, including redactions, manual changes, multiple fonts and visible cutting/pasting of text
- Sizable and refundable deposits

The occurrence of these red flags does not necessarily mean the transaction is fraudulent. Their presence, however, should motivate the equipment management professional to perform a more thorough analysis. This higher level of diligence should either provide a reasonable explanation for the abnormality or, if not resolved satisfactorily, justify rejecting the transaction.

The credit market dislocation of the past several years has exposed and crashed virtually all of the known “suspect” equipment fraud transactions. As a result, our collective portfolios have been thoroughly cleansed of equipment financing fraud transactions along with their accompanying losses. However, leasing fraud has been around for decades and will no doubt become more prevalent in the future. By understanding fraud risks and warning signs and taking the necessary precautions, you will be better prepared to avoid becoming another victim. ■



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¹*Fraudulent Financial Reporting: 1998–2007: An Analysis of U.S. Public Companies*, by Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson and Terry L. Neal. Copyright 2010 by Committee of Sponsoring Organizations of the Treadway Commission. www.coso.org/FraudReport.htm