

SOAP BOX

AVOIDING CORPORATE FRAUD

► STOCK ANALYSIS

How do you spot when something isn't quite right with a company, and avoid another nasty Enron-sized surprise? **Jamie Stewart** of the Eden Group, has some suggestions.

AT THE HIGHEST level, there are two common routes behind corporate collapse – honest failure, usually triggered by financial mismanagement, and straight fraud. In the days when brokers wore top hats and settlements clerks wore bowlers, market communication was restricted to gossip, letters and the occasional telegram. Rumours and news of difficulties at Company X spread outwards like sleepy ripples on a dozing pond. Unless it took the form of something spectacular, such as black tulips or a bubble in the South Seas, corporate failure was unexciting. It was slow, gradual and well flagged in advance.

Today, one wakes up and the shares propping up one's pension – Mayflower, Versailles, Enron, Equitable Life, Marconi, Parmalat – have suddenly lost 60% by breakfast time, and are suspended at close to zero by lunch. Global markets, instantaneous communication, 24-hour dealing, multi-market quotations, market-timing misbehaviour, technological tampering and foolishness or fraudulence have all already played their part.

"What can we do to make sure that it doesn't happen again?" asks the asset manager who has been caught by a nasty Enron exposure. The recommendation from the banks is to read their research, but broker analysts generate, on average, nine 'buy' and one 'hold' or 'sell' recommendations in 10. They are there largely to extrapolate next quarter's earnings from the last lot, and no more.

Independent researchers are not subject to the same pressures and expectations of an analyst at a bank or brokering house. They take the time and the trouble to identify what the investor really needs in order to succeed, without having a head of research or corporate finance breathing down their necks.

To give an idea of the tricky context in which the bank analyst works, consider the numerous recent cases of corporate failure and fraud. There is little doubt that innocent failure is invariably rooted in creeping financial deterioration resulting from a fatal combination of persistent optimism and relative inexperience.

Scuttled by fraud

The companies scuttled by shameless fraud all reveal certain characteristics, although the range of case-by-case variations is infinite:

- First, and most likely, is the deliberate and escalating misstatement of revenues, often involving a blurring of the

boundaries and the working definitions governing paid invoices, receivables, new orders, rebates, commissions, inventories and work in progress.

- Secondly, the fraud may well spring from off balance sheet debt and/or liquidity, more often than not vested in SPEs or SPVs (Special Purpose Entities, or Vehicles – as used by Enron and countless others).

- Thirdly, senior corporate officers may collaborate in developing and concealing the ways in which they gradually siphon off liquidity and make merry with the proceeds.

- Fourthly, the fraud is almost always perpetrated over a period of at least three years, and often far more, before it takes its final toll on the company.

So much for the roots of fraud. What of the clues and the evidence? The shared characteristic of these instances, invariably recognised with the wisdom of hindsight,

is that they can almost always be convincingly explained away to the puzzled auditor, compliance officer or shareholder within the context in which they arise – ie that year's accounts, the current business trends, changes in procedure, delayed returns in respect of the new product-line, and so on. This sparse trail of clues and evidence betrays its fraudulent origins by establishing a trend which, over the longer term, becomes distinctly at odds with the norms for the sector. It becomes visible under the microscope only to the occasional genius (in all probability that independent analyst) with the sharpened sense of long perspective and with an intuitive understanding of white collar criminal habits; otherwise it appears in the tear-stained rear-view mirror of the investor caught unawares.

The auditor chancing on this sort of anomaly and inconsistency, having swallowed the finance director's glib explanations, will check the substantiating vouchers and statements (also pre-doctored, of course), perhaps add a note to the accounts if he is conscientious or wants to cover his rear, or even both. The traditional broker's analyst, in turn, may or may not pick it up: if they happen to do so, they are only likely to apply it – if at all – as grist to the mill of the pre-ordained objective, rather than to pursue it as an unexpected aberration worthy of further investigation. The independent analyst, however, who has nailed their colours to the mast of a forensic or detective system, will spot it as an apparently benign cyst which might well be fed by a deep-seated cancer, and this is the professional who will win out.

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