

Specter of Fraud Concerns PE Execs

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By Kelly Holman

Long before news surfaced this past week that the Federal Bureau of Investigation was investigating embattled financial institutions American International Group, Fannie Mae, Freddie Mac and Lehman Brothers, the specter of fraud was a concern when doing business on Wall Street. It's been an equally insidious part of private equity dealmaking, too, if a survey by BDO Consulting offers any indication.

A large number of financial buyers have experienced fraud with losses of \$1 million or more, according to the 100-interview survey of partners and senior executives within private equity firms. It found that 37% of respondents have been exposed to corporate fraud and 40% thought the impact on returns was significant. Not surprisingly, financial services companies have attracted the most attention in light of the subprime mortgage market meltdown.

"Financial services fraud is peaking right now because of the troubles the industry is in," says Glenn Pomerantz, national director of the risk advisory practice at BDO Consulting, a unit of accountancy and consulting company BDO Seidman, which has handled some fraud-related assignments in the subprime market.

Robert Strang, chief executive of corporate investigations firm **Investigative Management Group**, says fraud often rears its head in times of economic dislocation. However, he notes the circumstances in the latest economic downturn differ in that "in a way the credit markets created this problem."

Strang, a former DEA agent whose company works closely with private equity firms on investigative matters, won't identify clients by name. But, he recalls one case involving a manufacturing company that had dire implications for its financial investor. "Our private equity investor was unaware that a second set of [accounting] books existed and by the time they found out about it, it was difficult to turn the company around," he says. "We've seen people who've used questionable accounting and wondered if it spoke to management's trustworthiness," says Carl Stanton, a managing partner at Wellspring Capital Management, a New York private equity firm. It's difficult to pin down exactly how widespread fraud is in private equity, because as one M&A broker says, "fraud is this industry rarely makes it into the press."

Private equity executives are old school when it comes to anti-fraud tactics, putting the most importance on employing traditional techniques. In the BDO survey, 72% indicated that conducting criminal and background checks on prospective employees was the most important aspect of fraud prevention, whereas 62% thought maintaining a board and audit committee with oversight responsibilities for detecting fraud followed a close second. Sixty percent relied on monitoring and updating anti-fraud controls for anti-fraud prevention and 56% used timely policies as an anti-fraud measure. Not many executives (22%) thought that compliance with Sarbanes-Oxley would aid in fraud prevention. However, 66% indicated that a comprehensive anti-fraud program would be at least somewhat effective in fighting fraud.

Fraud can range from mistating financial results or maintaining two sets of accounting records to family members establishing new businesses in violation of agreements with private equity owners to outright embezzlement. Pomerantz, who may conduct as many 25 to 40 fraud investigations a year, cited as an example of corporate fraud a situation where an employee processed credits for returned merchandise but also took the merchandise.

Buyout executives, meanwhile, rated their own investments more positively than US companies overall on developing and executing internal controls. Twenty-three percent gave high marks to US companies when it came to developing and implementing controls for preventing and detecting corporate fraud.

Although private equity buyers are always focused on acquiring a business for the best price, only 29% of dealmakers surveyed said they would be willing to pay a slightly richer premium for a business with a comprehensive anti-fraud program, according to BDO.

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