The Fraud Risk in Mergers & Acquisitions

A friend of mine unwrapped a Christmas present and was excited to open the box to discover her new gift. Her excitement turned to disappointment when she found a used candle inside the box. This was not a prank; someone had previously purchased the item, replaced it with a large used candle of approximately the same weight and returned it for a full refund. The store then restocked the deceptive box where it was repurchased again as a gift for my friend.

In my career, I have helped assist a number of companies through mergers or acquisitions that subsequently led to disputes or discovered fraud. These companies had, in their own way, discovered a used candle. Below are five fraud risks I have seen while conducting investigations involving mergers and acquisitions.

Employee background checks – Hopefully your company has a rigorous on-boarding process that includes an employee background check. The background check is an important control to prevent fraud and abuse because it prevents those willing to commit a fraud from ever getting inside the organization. However, what often happens in an acquisition is that the acquiring company doesn't perform a background check on employees at the company it is acquiring. As a result, fraudulent employees may be acquired along with the assets of the target company. These new employees gain access to new opportunities to commit fraud once a merger or acquisition is complete.

Adopting fraud – The due diligence process is intended to provide a comprehensive appraisal of a business, establish its assets and liabilities and evaluate its commercial potential. This often includes a quality of earnings analysis and other examinations intended to provide a true picture of the organization being acquired. Unfortunately, this process may not go deep enough to uncover employee misconduct in the form of procurement fraud or payroll fraud. Generally speaking, the procedures performed during due diligence are not designed to identify these types of issues, and as a result, with the acquisition of a company, you may end up adopting a fraud.

Systems integrations – After a merger or acquisition, often a decision has to be made to migrate one data system (general ledger system, payroll system, accounts payable system, etc.) to another or to run them in parallel. In one investigation, after a company had acquired a smaller competitor, the new parent intentionally migrated revenue and accounts receivable to its system platform and intentionally continued to run the legacy system in parallel so as to double count the revenue for the final quarter of the year. This was done in an effort to show that the acquisition was indeed a good business decision.

Layoffs – Often mergers or acquisitions result in layoffs. Layoffs may come in advance of a merger or acquisition in order to make an organization appear more attractive. They may also come as a result of the merger or acquisition in an effort to reduce expenses. On paper they make sense. Practically speaking though, there is inherent fraud risk associated with layoffs, particularly if they occur in the accounting or finance group.

Some degree of change is inevitable when doing any deal. Anytime an employee leaves an organization, their knowledge, expertise and responsibility leave with them. This impacts the control environment. A change in the control environment shifts the risk profile of the organization and, with it, the fraud risk profile. Employees often possess specific knowledge that isn't documented in policies or procedures, and that can take weeks, months or years to replace. These gaps, if left unaddressed, result in a weakened control environment that may provide more opportunity to commit fraud.

Accounting fraud –One area where investors and analysts must spend extra time is in navigating the post-transaction financials. Benchmarking, competitor analysis, year-over-year, quarter-over-quarter and analyzing same-store sales are all types of comparative analyses. One thing that makes comparison difficult is if the organization changes. Imagine if a company acquired another company every month for 16 consecutive months. How would you compare the performance to any other period, or to any other company? It would be extremely difficult. With all of the eyes of Wall Street upon it, one public company used its mergers and acquisition activity to hide its fraudulent recognition of revenue by hundreds of millions of dollars. When the company was faced with questions about performance, the answer was that the acquisitions created synergies that allowed the organization to take more market share and reduce costs. When you have unprecedented growth through acquisition there is no benchmark to know if the answers are reasonable - only time will tell.

So what can you do to help ensure you're not buying the proverbial used candle?

- Adhere to the standard due diligence process. Request audited financial statements and look for identified control weaknesses.
- Perform background checks on key personnel, and be sure that they go back a sufficient amount of time (background checks are subject to state and federal laws).

- Look for evidence of a robust anti-fraud program. Determine if there are whistleblower hotlines and codes of ethics and check if the organization has identified and mitigated its fraud risks. Obtain investigative reports of prior allegations of fraud, waste and abuse and understand the report findings.
- Evaluate the organization's third parties including accountants, attorneys and other advisors. Have they been screened by the organization? Are they reputable? Are they in good standing with professional societies?

For more information on ways to prevent fraud in a merger or acquisition transaction, contact Justin Snell by calling 770.396.2200.