A GUIDE TO

Fraud and how to spot it

An introductory guide to Fraud in the Invoice Finance Industry environment.

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CREDEBT

THE DEBTOR BOOK PROFESSIONALS

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INTRODUCTION

Fraud in an Invoice Finance environment

As an Invoice Finance Funder, you are highly susceptible to Fraud. Thankfully **overt Fraud is rare**, but it can take many forms and can be difficult to detect. It is essential that you know what to look for if you suspect your clients are committing Fraud.

Moreover, you need to know **what to do** when you suspect this is the case.

In this guide, we will give you the most common (and some less common) types of Fraud, the signs to look out for and how you can approach the issue with your clients in a way that poses the **least risk to your capital**.

Credebt are the **Receivables and Risk Management Specialists** and have more than 30 years of extensive experience in all industries. We have spotted several cases of Fraud that were missed or unconfirmed by the firm's own Auditors, IBR providers and other firms carrying out audits.

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CHAPTER ONE

WHAT IS FRAUD

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Definition of Fraud

Fraud is being committed when there is the **intention** to **gain an advantage** and to **avoid detection**.

When this is the case you have to look at whether it's a sustained activity or a one-off and whether there are more parties involved or it is a 'lone wolf'.

You will have to look at who, why, how and when the Fraud is committed and **see if it can be proven**.

The spectrum of Fraud

There are various types of Fraud, and they range on the spectrum from **Errors to Overt Fraud**. An overt fraudster is likely to have a planned exit and can be very good at covering their tracks. Luckily this is relatively rare in the UK, but it's important not to ignore it.

And remember that even nice people can be desperate, and desperate people will do **desperate things** to get out of a desperate situation, so as a Funder you have to be able to look behind the curtain to know what's really going on.

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CHAPTER TWO

TYPES OF FRAUD

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In the Invoice Finance context, there are seven types of Fraud to look out for.

<u>The two main types of Fraud are:</u>

1. Fresh Air Invoicing
2. Suppressed Credit Notes or Write-Offs

Then there are three further <u>variations on a theme</u>, which are harder to spot:

3. Pre-invoicing
4. Banking Cash & Teeming and Lading
5. Sales Ledger Report Manipulation

And finally there are <u>sophisticated multi-party Frauds</u>:

6. Cross-firing within a group
7. Debtor Collusion

1. Fresh Air Invoicing

This is where the company is raising **fictitious transactions** and invoicing them.

They are usually **large amounts** to their top customers.

What to look for:

- Round amount invoicing
- Big credit notes or journals,
- Differences in monthly reconciliations
- Expanding Debt Turn and more old debt
- The absence of (valid) Proof of Delivery
- Invoicing out of line with the norm
- Special ‘one-off’ projects or large sales to new customers

2. Suppressed Credit Notes

When Credit Notes are suppressed or there are large numbers of write-offs you have to establish how long is an **acceptable delay** and whether the client is efficient at dealing with returns, before jumping to the conclusion that it may be Fraud.

What to look for:

- Extending Debt Turn
- Falling volumes
- Falling values of Credit Notes and Journals
- Large reconciliation differences
- Short payments from customers
- Delayed payments from customers

3. Pre-invoicing

Raising an invoice **before a transaction is completed** can be Fraud, but it can also potentially turn into a valid transaction, so once again you need to be careful before jumping to the wrong conclusion.

What to look for:

- Increasing Debt Turn
- Poor results from Debtor Verification
- Changes in Credit Note profile and pattern

"Nice people who are desperate can also commit Fraud."

4. Banking Cash and Teeming & Lading

Teeming and lading is the redirection of customer receipts for a short period. It's allocating one customer's payment to another customer's account to make the books balance, often to **hide a shortfall or theft**.

This is more likely to be a 'lone wolf' or rogue member of staff, but be aware that not all misdirection is cash fraud, as some of it can be accidental.

What to look for:

- Big differences in monthly reconciliations
- Receipts out of sync on bank statements
- Reluctance to comply with repaying direct cash

5. Sales Ledger Report manipulation

This often takes the form of **re-ageing the Debt** to make it look younger than it actually is, thereby overstating fundable Debt.

It can also be actioned by cutting the data at something other than the month end or **manipulating the reporting software** to show incorrect data.

What to look for:

- High levels of journals or intra-group balances with adjustments prior to month end
- Inconsistencies from one aging to another
- Unexplained divergencies from the norm or restricted access to back-up data
- Invoicing that has a high degree of dilution or in-built error

6. Cross-firing in a group

This is when lots of companies in an informal or formal group cross-invoice and cross-pay to **inflate the figures**.

This can be like a carousel that gets bigger and bigger and can be very difficult to spot.

What to look for:

- Lots of repeat transactions for only increasing amounts
- Complex groups with several funders
- Know your Customer, Know your Business

7. Debtor Collusion

This takes many forms but tends to run within ‘communities’, and as there is a real **intention to deceive**, it can be very difficult to detect.

What to look for:

- Debtor Verification results that are too good to be true
- Non-standard transactions such as loans from customers
- Badly explained dilution

> *“In cases of Fraud, suspect all, but accuse none.”*

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CHAPTER THREE

DANGER AT COMMENCEMENT

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With all types of Fraud, there is a high danger at the **start of a new client relationship**.

You don't yet know the company and their business, and it will take time to find out their practices and norms.

They may be signing up with **several Factoring Companies** at the same time, and you don't know if your initial payment goes to the right place.

They may draw down on both the Invoice Finance and Supply Chain Finance **on the same debt**.

What to look for:

- A track record of bust companies
- Where customer receipts come from
- If in doubt, request a customer remittance advice and check dates
- Get to know your customer and their business as soon as possible

Normal business or fraudulent giveaways?

Every business has their own way of getting and keeping customers, and it's important that you know as soon as possible **what is normal and what's not**.

When they have practices that are very different from the industry standards, it should be a **Red Flag** for you to investigate further (even though in most cases there will be no Fraud).

This can include things such as:

- Giving amended terms to certain customers
- Working on a Sale or Return basis
- Giving extended Payment Terms
- Extending the manufacturer's warranty
- Borrowing from customers (this can be money, goods or fuel for example)
- Something unique to their industry

In every case it is important to ask lots of open question, listen well and be very nosey. If they have nothing to hide, they will be happy to explain their processes to you.

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CHAPTER FOUR

HOW TO APPROACH THE ISSUE

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When you suspect Fraud, it's important to **approach the issue sensitively**. Do not ignore it but stay calm and start to investigate.

You must **suspect all but accuse none** (until you have proof). The risk of tipping-off a money launderer can have serious consequences for the Finance Company staff.

You want to try and build a **body of evidence**, confidentially. Always discuss it with your line manager and agree on a strategy.

And when you're ready to confront the Company, it is best done **through a third party**.

Thankfully, true, intentional, pre-meditated Fraud on Invoice Finance Companies is relatively rare in the UK.

However, stupid, desperate people doing stupid, desperate things is, unfortunately, **more common**.

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CHAPTER FIVE

A CASE STUDY

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Bank expecting £1.2m loss gets full repayment of capital

When a major Bank did an audit on their client, a Food business in the South East of England, it came back inconclusive. They suspected something wasn't right and we were instructed to carry out a **Debtor Collateral Review**.

We discovered that from an **alleged £5.4m ledger**, over £2m was inter-company and connected party transactions, and £1.6m was **confirmed Fresh Air Invoicing**, with a further £300K suspected as being so too.

That meant that the **real value** of the £5.4m Ledger was only **£1.5m** and the bank was left exposed to a high risk as their Funds Out position was **£2.7m**.

This was a complex case, and a decision needed to be made that would recover the Funder's position to a point where the Funds Out and the real value of the Ledger at least matched, otherwise a large write off would be required. They were looking at a potential **loss of £1.2m**.

ACTIONS & RESULTS

In discussion with the Funder it was agreed that a substantial **verification exercise** would take place. Collections would be closely monitored by us and all new invoices being uploaded would be scrutinised to ensure they were correct. The client was left to believe that their story surrounding the Ledger had been accepted.

Only **Critical Payments** would be allowed and the Client was given **Notice of Termination** and told to look for an alternative Funder. The majority shareholders were expected to fund the business in the interim period.

Within 3 months of our initial involvement, all invalid invoices had been written off, new invoices uploaded were correct and the **Funds in use** had been reduced from £2.7m to **£600K** while the Ledger had been tidied up and now reflected the true value owed to the company.

This resulted in the business being far more attractive to alternative Funders, and the client was **managed away**, and our Funder client was **repaid in full**.

CONCLUSION

How Credebt can help

Credebt have many years' experience in dealing with cases in all industries, and when you suspect Fraud, we suggest you contact us immediately to get us to do a **Free Debtor Collateral Review**.

This can be done under the guise of a regular review, and because of our extensive experience, we know how to handle this sensitively and **without causing unnecessary concern**.

We have spotted several cases of Fraud that were missed or unconfirmed by the firm's own Auditors, IBR providers and other firms carrying out audits, so even if you have done your own investigations, it is well **worth getting us involved**.

We can also provide a day's **training** to your staff on **How to spot Fraud**. This has been proven to be very effective in getting your staff better at spotting the signs of Fraud and knowing what to do next.

ARRANGE A FREE

Debtor Collateral Review

To find out your position, contact us for a free, no obligation, **Debtor Collateral Review**.

Call us on 0845-6385256

Email: glen@credebt.co.uk

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