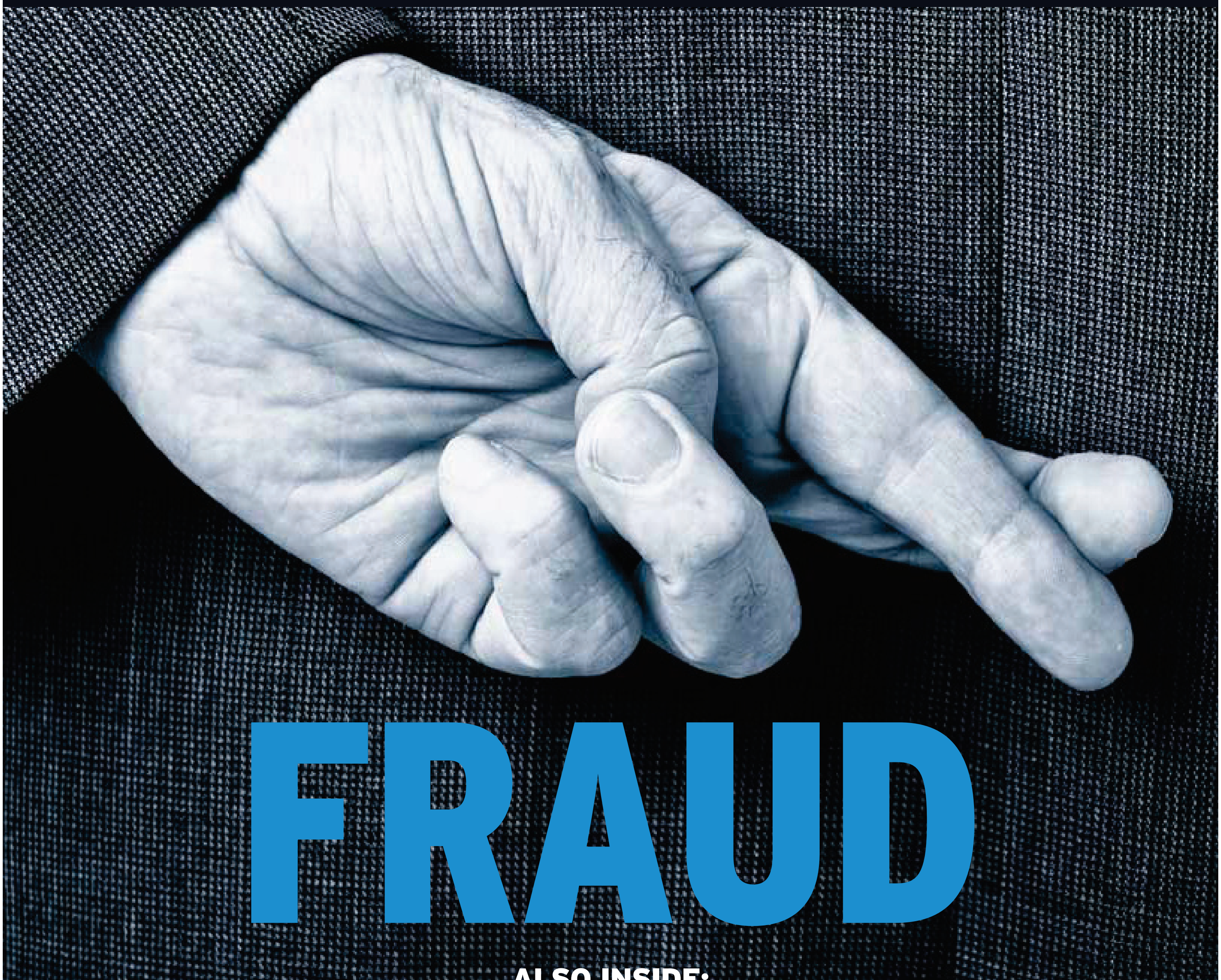
A PUBLICATION OF THE INTERNATIONAL FACTORING ASSOCIATION

COMMERCIAL FACTOR

SUMMER 2011 • VOL 13/ No. 3



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The Pathology of Fraud

In this article we cover a sprinkling of anecdotes that highlight some of the more subtle, insidious, and instructive instances of fraud that have come our way, and the circumstances surrounding their incidence, unearthing and prevention. **BY RISHI KUMAR AND JIM BERTIE**

As financiers in the factoring and commercial lending market, our work is a daily dance of thrust and parry vis-à-vis clients that are altogether too often, compelled by malice or circumstance, attempting to defraud us. While the workings of the everyday-home-variety fraud is the stuff of oft recited lender lore and the accompanying defensive measures de rigueur in all manner of Risk Management 101 training, as technology and business processes evolve so do the artifices employed by perpetrators. In this article we cover a sprinkling of anecdotes that highlight some of the more subtle, insidious, and instructive instances of fraud that have come our way, and the circumstances surrounding their incidence, unearthing and prevention.

Domain Dissonance

One of our prospects was a company that sold high-end computer equipment and was looking to factor invoices to its primary customer, DreamWorks. The lead was generated on the internet, the prospect was out of state, and all diligence items were being communicated electronically. There was one large invoice to be funded at closing and it was going to be verified directly by the debtor on email. The purchasing manager at DreamWorks immediately confirmed the purchase order and invoice by email with attachments on the corporate letterhead. However messages and calls for voice verification were not returned for several days.

Remarking the difference in responses to calls versus emails, we started reviewing the invoice and other paper work again, only to find that all the email responses had come from users on a domain that was spelt just slightly differently than the DreamWorks corporate domain. The prospect presumably controlled this domain and spelled was using it to email the verifications. At this time we also surveyed the map with satellite images of the address the prospect had listed as their operating location and found that it was an empty lot.

The close call served as a reminder that an overeager invoice debtor is as much a warning sign as one that refuses verification, that electronic communications should be subjected to as high a bar for authentication as any other, and that no amount of searching and data can quite replace the age old wisdom of a site visit and a tête-à-tête.

Tech Travails

As much of the retail sector moves towards EDI (Electronic Data Interchange) for all wholesaler to retailer communications such as purchase orders, invoicing, and shipment notifications, the job of factors has been simplified on the one hand with the promise of a high degree of automation, and complicated on the other when it is accompanied by a false sense of security stemming from the faith in the infallibility of high technology that has little human intervention.

We found ourselves slipping in the same trap in the case of a client who was a domestic manufacturer of consumer durables shipping to several large retailers. There were a large number of small invoices at the store level. All invoicing was through EDI and we received a copy of the communications exported directly from the EDI VAN (Value Added Network). Subsequently we also received a copy of the responses from the retailers' systems, the EDI Functional Acknowledgement, verifying receipt of the invoice and confirming that the invoices had passed preliminary automated validation. The goods were invoiced FOB origin and the retailers were responsible for the third party pick-up of the goods. In the ordinary course of business a week or two following shipment, invoice verification was made available at debtors' accounts payable databases. After some weeks of funding the invoices on this basis, we saw a surge in invoicing that did not seem to be making it to the debtors' AP.

On our guard now, we took to verifying each shipment directly with the trucking companies and found, to our dismay, that many of the tracking numbers, while valid in format and current, had been generated ahead of time and reserved by the carriers based on the client's bookings but the corresponding shipments had never been made. The retailer EDI validation was fooled by ensuring that every invoice generated matched an existing valid purchase order, and had shipment tracking information that had been generated by sending ship notifications, and booking trucks for shipments that were not made.

We learned our lesson the hard way that, as with most technology, Garbage-In leads to Garbage-Out, that EDI too was a protocol that could be easily compromised with little sophistication, and that layering many types of verification is the best way to manage the risk of fraud.

The Co-opted Consultant

On occasion we hire consultants as on-site monitors at our clients' premises on days with high shipment volume to verify that the goods are loading as per plan and to collect all the verification information and supporting documentation needed such as bills of ladings. Since the work of lolling at loading docks to watch trucks is relatively unexciting, we stay clear of the high power professional types for the demands of this particular brand of labor and generally look to temporary staffing agencies to fill the ranks of our monitors delivering real time verifications.

In the case of one client we saw our feet-on-the-ground strategy for verification broadsided in an unexpected way. The monitor had been at the client's facility for several days. She was delivering reports timely at the end of every day and we were funding based on them. It appeared that every single shipment was being made as per plan and the operation was like clockwork. The first sign of trouble came when we were asked to fund invoices for which the shipment was not on the monitor's verification report. Within minutes of challenging these invoices we received a revised report from the monitor adding the shipments that were missing before. Soon after we called the client's office and the company line was answered by the monitor as the receptionist and phone operator for the company at a time when she should have been at the warehouse watching shipments.

Further digging revealed that the client had offered the monitor a full-time position to relieve her of the drudgery of temp jobs if she co-operated with him in the shipment verification and she had taken the bait. We have since started to change monitors and consultants frequently to keep them from developing a relationship with the client.

Wary Watchmen

At the end of the day, when it comes to the occurrence or attempts at fraud, the only thing we can say with any certainty is the sheer inevitability of it in any portfolio of reasonable size and vintage. While a consistent and detailed risk management policy lies at the heart of all early detection and prevention, the surest defense, and the cornerstone of every such policy, is constant vigilance. •

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