Key fraud risk considerations for private equity investors

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As nations shut down to flatten the curve of COVID-19, a substantial impact can be seen on businesses across the globe. In an already volatile economy, the outbreak has added to the turbulence. Private equity (PE) funds, being no different, are seeing a slowdown in investments. Although cash-rich PE funds may trigger increased activity as the impact on health subsides, risk-averse funds will have to wait and watch till the market stabilises.

Some sectors, such as healthcare, technology and e-commerce, may see growth at the time of this crisis while others may witness a substantial slowdown, giving funds a doorway to make investments at a much lower valuation. Fund managers may consider some distressed deals, especially in the hospitality and entertainment sector, as these sectors have been most impacted by COVID-19.

Having said that, the key agenda on every PE's list is, in all likelihood, to protect their existing portfolio. The dry powder reserved for investing can be now used in business continuity planning. Amidst this uncertainty, funds need to be careful of the increasing risk of fraud. PE and venture capital firms are more porous to this risk due to their enhanced dealings with third parties. They need to be careful of not only internal fraud but also fraud by and on portfolio companies and other third parties.

When economic survival is threatened, the demarcation between what is acceptable and unacceptable blurs and frauds like in the case of Luckin Coffee and TAL Education Group[1] could surface and so could the disputes and litigation between parties.

1. Following Luckin Coffee, TAL Education discloses sales fraud, authored by Song Jingli on 10 April 2020 on behalf of TechinAsia and accessed by KPMG in India on 04 May 2020.

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What should a PE be careful of then? There is no way to ensure complete safety but surely there are ways to be more alert and diligent to reduce the risk. The following are some areas where caveat emptor will be the corner stone of transactions.

Window dressing

Business managers like to present the operations as showing healthy profit. However, they often resort to certain tactics to prepare the financial reports that do not actually reflect the correct position; window dressing or profit smoothing is one such method. Steinhoff International Holdings NV was recently fined USD3.6 million for manipulating its financials and substantially inflating the group's profit and asset values[2] .

The infamous "Community Adjusted EBIDTA" of WeWork is another example of how companies manipulate the presentation of financial information[3]. Investors need to be cautious of what they see and what the reality might be. In-depth scrutiny of financials would be imperative to gauge the impact of the pandemic and how lasting its effects may be on the business.

Cybercrime

Economic slowdown is a breeding ground for fraudsters and this pandemic situation is no different. Sudden occurrences of ransomware and phishing attacks, social engineering and other cybercrimes has seen a spike. It is no more a question of 'if' an attack occurs but 'when' an attack occurs. Florentine Banker group targeted three large banks in the British and Israeli financial sectors. The attack reportedly began with the group setting up a phishing campaign that targeted the individuals in the organisation who authorised money transfers. This included the CEO, the CFO and others. After gaining access to a victim's account, the attackers read the emails stored therein to learn about the channels used to process money transfers and to get more information about who might be involved in completing such a transaction. The attack led to transfers of USD1.3 million, half of which were recovered during the investigation[4].

Although there are no statistics to show that PEs are hit more often than others, the industry could be a victim of a growing number of targeted and increasingly sophisticated attacks. Attackers are moving away from the 'spray and pray' attacks to big games that promise bigger paydays.

Data breach and intellectual property theft

Another technology-driven problem that may see an increase is data breach and theft of intellectual property (IP) and/or confidential information. The Federal Bureau of Investigation stated that 2019 saw many cases of proprietary information theft and that IP theft is a growing risk[5]. With majority of employees working from home, sensitive information may be more vulnerable to theft than in the normal work environment. Very recently, Indonesia's e-commerce giant Tokopedia, which is backed by large PE firms, reportedly lost a database of 91 million users to hackers[6], leading to not only substantial reputational impact but also potential exposure to several lawsuits and other regulatory issues.

2. Steinhoff Gets USD3.6 Million Fine Following Accounts Scandal, authored by Franz Wild and Janice Kew on 12 September 2019 on behalf of Bloomberg and accessed by KPMG in India on 04 May 2020.
3. The WeWork S-1t Show: How the co-working giant went from a USD47 billion valuation to talk of bankruptcy in just six weeks, authored by Dakin Campbell on 28 September 2019 on behalf of Business Insider India and accessed by KPMG in India on 04 May 2020.
4. The Florentine Banker Group Tricks Banks in a Half Million GBP Heist, published by Cyware Hacker News on 05 May 2020 and accessed by KPMG in India on 07 May 2020.
5. Intellectual Property Theft a Growing Threat, authored by Elizabeth Lee on 15 January 2020 and accessed by KPMG on 04 May 2020.
6. Indonesian e-commerce giant probes reported breach of 91 Million credentials, authored by Jeff Stone on 04 May 2020 on behalf of Cyberscoop and accessed by KPMG in India on 07 May 2020.

Complex regulatory interactions and, therefore, enhanced risk of bribery

In India, the complex regulatory framework requires organisations to comply with directives received from various authorities, including central, state and local municipal authorities. In the present evolving COVID-19 situation, new directives are being issued by authorities almost every day. Government interactions may also see a spike with increased regulatory approval requirement related to supply chain and financial aid. For example, according to a directive dated 17 April 2020, prior approval from the Centre is required for foreign investments from countries that share the border with India[7].

As organisations face intense pressure to kickstart and makeup for the lost time, businesses may fast-track the onboarding of new suppliers, customers, agents and other business partners, increasing the risk of incomplete due diligence. In 2019, a Wisconsin-based digital and print marketing provider agreed to pay a fine of nearly USD10 million for violation of Foreign Corrupt Practices Act.[8] The company's China-based subsidiary used sham sales agents to make and promise improper payments to employees of private and governmental customers to secure business. Similarly, in February 2020, an American healthcare solution provider settled USD8.8 million for using resellers and distributors in China to bribe government officials[9].

Brushing old frauds/losses under COVID-19

Portfolio companies may use the garb of the pandemic to cover already incurred losses arising out of inefficiencies or prior frauds or look to manipulate revenue, costs and profit/loss figures for the upcoming period. To give an example, the auditors and management of multiple organisations were unable to perform physical stock verification as on 31 March 2020 due to the nationwide lockdown.[10] In such situations, the auditors considered alternative procedures to provide an opinion on the inventory. The subsequent valuation will have to be scrutinised to ensure inventory frauds are not covered up in the delayed verification.

PE funds may require close evaluation of the results published by investee managements to ensure that the reported figures are appropriate. The projection methodology of estimated returns from investments may require a relook.

Increased risk of internal fraud

Bruce Dorris, president and CEO of the Association of Certified Fraud Examiners (ACFE), stated in an article[11], "Pressure from an economic crisis also affects a company's employees and can make the company itself a target. The most commonly accepted model for explaining fraud in the workplace is the Fraud Triangle, which states that three factors generally must be present in order for a person to begin committing occupational fraud— pressure, opportunity and rationalisation. In times of economic crisis, employees' personal financial pressures tend to rise, which is often where the decision to steal from an employer begins".

The present economic crisis has forced many organisations globally and across sectors to enforce pay cuts, increasing the financial and psychosocial pressure on employees. PE funds and portfolio companies need to keep their employees motivated and, at the same time, strengthen their internal controls to prevent these frauds.

7. Press Note 3 released by the Department for promotion of industry and internal trade established under Ministry of commerce and industry, Government of India on 17 April 2020 and accessed by KPMG in India on 04 May 2020.
8. Wisconsin Marketing Company pays nearly USD10 million to settle Foreign Bribery Charges, authored by Kristin Broughton on 26 September 2019 on behalf of The Wall Street Journal and accessed by KPMG in India on 04 May 2020.
9. Cardinal Health pays SEC $8.8 million to settle China FCPA offenses, authored by Harry Cassin on 28 February 2020 on behalf of fcpablog.com and accessed by KPMG in India on 19 May 2020.
10. Audit Companies exploring digital options to clear lockdown hurdle, authored by Ruchika Chitravanshi and Sudipto Dey on 10 May 2020 behalf of Business Standard and accessed by KPMG in India on 19 May 2020.
11. Coronavirus Pandemic Is a Perfect Storm for Fraud, authored by Bruce Dorris on behalf of ACFE and accessed by KPMG in India on 07 May 2020.

Related party transactions

This is the area to watch out for not only in this crisis but also through the life of any investment. We have investigated many instances wherein the investee company embezzled funds through related party transactions and either brought them back into the company by showing as their own share of investment or used that money to grow other businesses. Money trailing becomes extremely important in such a scenario. PE funds have become cautious while investing by conducting financial and promoter due diligence. Ongoing monitoring is, however, something that needs to become a common practice.

Increasing disputes

The pandemic may lead to an increase in disputes due to restructuring of shareholding agreements, purchase price adjustments or alleged breaches of representations and warranties. These may also relate to sellers' obligations, indemnifications, earnouts or unforeseen liquidity needs of the target soon after closing the investment transaction. Mechanisms, such as earn-outs mean that the buyer might have to continue to pay the seller for years after transaction conclusion. As long as that is happening, a dispute is always on the cards, especially considering the current situation.

In 2020, a dispute arose between an insurance company and a large global professional services firm that sells a range of financial risk-mitigation products, wherein the insurance company was accused of defrauding the firm when it acquired the company four years ago in a USD300 million deal. The contract included certain earn-out clauses that could not be honoured, due to potential fraud and omissions by the insurance company and 200 million reais is being sought from the insurance company as damages[12].

PE firms in an attempt to safeguard their interest, may potentially invoke the force majeure clauses in their agreements to suspend cash outflow. PE firms must also be cautious of the fact that the customers of their investee company may invoke such force majeure clause, which may have a negative impact on return on investments. One of India's large online hotel booking website backed by international PE firm, has written to hotel owners invoking 'force majeure' clause on their agreements as the COVID-19 pandemic has severely impacted their business. The company stated that since hotel revenues have dwindled and are unlikely to improve in the next few months, it is compelled to exercise its force majeure rights in suspending payments of the monthly benchmark revenue or any other amount payable to them.[13]

12. Exclusive: Aon alleges fraud in arbitration over USD300 million Brazilian deal: documents, authored by Tatiana Bautzer on 10 March 2020 on behalf of Thompson Reuters and accessed by KPMG in India on 4 May 2020.

13. Oyo suspends payments to hotels; Partners say clause not in contract, authored by Anumeha Chaturvedi on 3 April 2020 on behalf of The Economic Times and accessed by KPMG in India on 4 May 2020.

How we can help?

The results of the survey published by ACFE on 26 April 2020, about the effect COVID-19 has on fraud[14], indicated that 90 per cent of the respondents reported that they had seen an increase in scams targeting consumers, with 51 per cent believing that the rise had been by a significant amount.
PE fund managers will now have to be more fraud aware than ever before. A few sectors with heightened risks due to COVID-19, such as travel and tourism, hospitality and entertainment, industrial manufacturing and automotive and public and private infrastructure, may require heightened vigilance. Enhanced forensic due diligence on business and promoters; investigation on cash burnt portfolio companies to evaluate whether it was COVID-19 or potential past or present fraud; periodic anti-bribery reviews; appropriate quantification of losses during litigation and setting an overall tone of compliance appears to the need of the hour for the investors.

KPMG in India can assist PE funds in fraud detection and mitigation activities for themselves as well as the investee/proposed investees across the investment lifecycle in the following ways.

Pre investment forensic due diligence

A typical diligence may include assessment of financial, regulatory, tax, technological and legal implications of a deal. It's often, however, the hidden reputational risks that have the largest potential to unexpectedly derail a critical strategic investment.

We, using advanced research methodologies, help gather detailed insights and assist in screening companies' affiliates, stakeholders or key executives for unforeseen risks.

We also assist PE firms perform a detailed forensic review of transactions of investee companies. This helps assess the financial health of a target opportunity and may include a review of financial transactions, accounting, compliance and operations.

Implementation of an ethics framework for portfolio companies

Many PE firms are investing in start-ups or companies that are in the initial phase of operation. The corporate governance of such companies might not be as strong as those of large established corporates. We help PE firms implement an ethics framework in investee companies that consists of robust policies and procedures on aspects of a whistle-blower mechanism, risk mitigation, incidence response plan, anti-fraud plan, code of conduct and anti-bribery policy.

Cyber investigation and data breach forensics

Assistance can be provided to PE funds for their target organisations as well as for their portfolio companies in responding to cyber threats effectively and efficiently with our bouquet of services ranging from rapid cyber incident response, containment of threat, continuous monitoring and training and capacity building to prevent future incidents, respond to data breaches or conduct assessments to remediate data leakage.

Our forensic technology services are equipped to provide remote systematic approach data acquisition of the full spectrum of modern digital sources with efficiency and discretion. In the present condition, our technology experts are conducting remote dead box/bulk data collection with assistance from local IT teams as well as cloud based forensic data acquisition.

Fraud and misconduct investigation/end-use monitoring

Post investment, PE firms are concerned about the utilisation of funds by portfolio companies. PE firms may want to ascertain whether the operations of business are conducted in accordance with the shareholder agreement and in a legally/ethically correct manner. We help firms by monitoring the utilisation of investment funds to identify instances of misconduct, siphoning or impropriety (including misrepresentation in financial statements) by the promoters/senior management/employees of the investee company.

14. 90 percent of Anti-Fraud Professionals Have Seen an Increase in Consumer Scams Due to COVID-19, published by ACFE on 26 April 2020 and accessed by KPMG in India on 04 May 2020.

Anti-bribery and corruption (ABC) reviews

Our compliance and investigation team can assist PE funds in identifying probable risk factors, which might impact their business negatively. We conduct diagnostic reviews for current and proposed portfolio companies to check existence of, and compliance with, a detailed ABC framework. We attempt to check for transactions incurred by the organisation or third parties on their behalf during the lockdown period in contravention to ABC laws and regulations.

Dispute advisory services

We help PE firms in various stages of an arbitration or litigation with portfolio companies. Our team can assist in the resolution of commercial or contract disputes.We can also provide support to the legal team by dissecting complex issues and providing compelling arguments on financial, commercial, valuation and accounting aspects, timely contractual recourse taken to escape penalties, performance and invoking of force majeure.

Valuation and quantum determination

We help PE firms and their investee companies in valuation of intangibles and calculation of losses sustained by parties on account of COVID-19 related business disruption. We can help interpret contractual obligations to arrive at accurate figures and also help provide an impartial opinion of the amount of money involved/tied up in the dispute and identify where the liability lies. Such quantification can lead to successful dispute resolution.

Third-party risk management

KPMG in India can assist PE funds in evaluating third-party risk for their investee company with increased emphasis on re-evaluation of vendors, supply chain resilience and consistent monitoring. The risk management coverage may include reputation risk analysis, business continuity and key personnel risk.

Intellectual property and contract compliance review

Organisations rely on multiple partnerships to create, market, distribute and/or sell their products and solutions. These partnerships, if not monitored, can result in possible violations of IP rights/contractual obligations and impact costs.

We help PE firms analyse key business relationships of investee companies to identify compliance-related gaps or instances of under reporting and offer suitable recommendations for course correction. Our services include royalty compliance reviews, license compliance reviews, contract/agreement compliance reviews and reseller and distributor reviews.

Prevention of sexual harassment awareness

As a proactive approach, we also assist in increasing awareness among employees through e-trainings and create awareness related to the applicability of prevention of sexual harassment regulations.

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