Red Flags for Fraud

When investors analyze a company, they sift through mountains of data — financial metrics, operating metrics, qualitative analysis, and more. But the common denominator in most of the data available to analyze a company's past and future prospects is that the data is provided by the company itself — in financial statements and securities filings, in press releases and conference calls, in industry conferences and on their website. The vast majority of the time, the information provided is accurate and reliable. But there have been and will continue to be bad apples in the bunch, companies where fraud rots away at the foundations of the data which they disclose.

Wherever fraud is eventually discovered, the end result is disastrous for investors. Therefore, it is extremely important to have antennas attuned to the possibility of fraud — to know and to learn to recognize the signs that indicate the possibility of fraud. These red flags are not one hundred percent dispositive. They are not absolute proofs of fraud. Often, they are not even probable indications of fraud. But they raise the possibility of fraud to an uncomfortable level, where the investor has to think long and hard whether to be involved, even at what superficially seems to be a very attractive stock price. Sometimes, with only one or two slight indications, it may be more of a yellow flag, and perhaps the investor will choose to invest anyways. But he must do this with eyes wide open and upon careful consideration.

There is no single right way to list and organize these red flags, but we have chosen to categorize them into three main areas where it is important to pay close attention: People, Accounting, and Narrative.

People

This is really the beginning and end of any investigation for fraud. The red flags for which we are keeping an eye out all lead to the specific suspicion that management is untrustworthy and possibly committing fraud. Fraud doesn't just happen. Fraud is committed by people. And very often, fraud is committed by people with a history of fraud. It is, indeed, highly unlikely that the major fraud necessary to ruin a public company is management's first fraud. So, history of fraud is the very first thing to keep an eye out for. The main reason we need to pay attention to other clues as well is because not all fraud is *caught*, and this public company may be the first time that management's fraud comes to light. Ultimately, if there is any whiff of issues with management integrity, you really need to run for the exit.

All that touches the impure is impure

It is not enough to examine the CEO himself to see if he has been caught previously committing fraud. You need to widen the net. If the CEO or chairman or majority shareholder, etc., is associated with known fraudsters, if their names keep on coming up in other contexts where fraud was committed, even if they were not directly implicated, you want to run for the exit. Birds of a feather flock together, and like-minded men do as well. If a person's circle of advisers, friends, and partners keeps on featuring fraud, you need to stay away.

Sometimes, things are less clear and a judgement call needs to be made. There was one company where we specifically met the management team just to assess this very point. The background: A private company was sold by the founders to a public company which was headed by unsavory characters, and this subsidiary was now being spun out by the original founders. Was this just a case where a public company offered them good money for their company, and after they came onboard, they found themselves uncomfortable with

their new partners and are looking to split? Or did the association run deeper and the partnership more sinister? We were quite concerned about this and wanted to assess their reasons for spinning out, their relationship to the parent company's principals, and whether they would defend those principals. Upon talking with them, they more or less threw their erstwhile partners under the bus (within reason, because you can't expect anyone to accuse someone else of outright fraud in conversation with a stranger). Ultimately, we were able to put our concerns to rest, we invested, and we saw very solid returns.

Self-dealing

This is pretty self-explanatory. A public company is not, or should not be, a private fiefdom to carve out lucrative side deals for management. Perks are fine, but frontrunning the company, buying divisions off the company for a sweetheart price, etc., etc., are not fine. This can happen in so many ways, and somewhat surprisingly, the self-dealing is often spelled out in public filings. I guess because the self-dealing is usually technically legal. Legal it may be, but a red flag it definitely remains.

Trustworthiness

I mean something very simple here. Do they do what they say they will do? This is one of the many things I look out for when reading transcripts from past quarterly calls. Most companies give guidance, and they're usually a month or more into the quarter when doing so. At that point, giving semi-accurate guidance should not be rocket science. Do they hit or beat their numbers or are they constantly guiding for contract wins and revenue that simply never materialize? This issue was the main thing that soured me on Wandisco when I researched the company in 2021.

Things happen, of course, and it's okay for a company to miss guidance once or twice. But if they're constantly missing guidance, best case scenario is that they're deeply incompetent — hardly a stellar buy signal either. Always hitting the guidance on the nose can be suspicious as well, as it may point to massaging the numbers (or worse) to stretch and hit the guidance. What most companies do, and what you want to see in a company you're looking to invest in, is to guide for what they're comfortably sure they can hit and then exceed that. Guidance is not usually meant to be management's best guess as to what actual revenue and income will be, but rather management's most conservative guess. Analyze their track record with that in mind.

As I said before, this red flag is what kept me from considering Wandisco for investment in 2021. As I'm writing this, I searched to find out what happened to Wandisco in the interim. And lo and behold, I find that "significant, sophisticated and potentially fraudulent irregularities with regard to received purchase orders and related revenue and bookings" were found in 2023, trading was suspended for more than four months, and the stock cratered. I'm glad I dodged that bullet.

Sudden C-level exits

This is an area where you have to learn how to parse press release language. If someone is leaving the company due to a medical condition, that usually means that they have a medical condition. (I guess if you have a slew of those, though, you have to start wondering what's in the water cooler.) If someone from the executive team is taking a more prestigious, higher-paying CEO job elsewhere, that's also not necessarily a cause for concern in and of itself, especially if they're giving customary notice and a transition period. But if the CFO is suddenly retiring "to spend more time with their family" or "to pursue other opportunities", that is a bad, bad sign. Red flag.

Accounting

Flow-through

An important part of analyzing the accounting of a company is tracing the flow-through across the various accounting statements. You need to follow the revenue and costs from the income statement and see how and where that ends up on the balance sheet. You need to reconcile the cash flow statement with the income statement. Besides for giving you a deeper and better understanding of the company's business and finances, this exercise can uncover leading indicators of fraud. Management can't just make up a rosy bottom-line number and call it a day. Any fraud will necessarily involve falsifying many other numbers to get to that rosy bottom line. And when the numbers aren't real, people often have a lot of trouble adjusting the made-up numbers to come out looking right, so a careful eye can pick up on shenanigans.

One basic indicator to keep an eye on is cash. Cash is the hardest thing to falsify. Any competent auditor (although unfortunately, not all auditors are competent or honest) should be able to ascertain that there is indeed cash in the company bank accounts that amounts to the number listed on the balance sheet. When revenue and income is faked, which is by far the most common fraud, it is hard to correspondingly fake cash. That forces the supposed profits to have to fit in elsewhere, be it in bloated inventory figures, account receivables, capex — somewhere or anywhere other than actual, hard, cold cash. And when quarter after quarter of supposedly stellar profits never manages to show up as cash, that leaves you with something to think about. Red flag.

Business done for numbers, not for real business reasons

The subtitle says it all. A deal is announced, a complex deal with lots of moving parts, but when you painstakingly piece all the parts together, you realize that not much economic activity actually occurred. What occurred was done for *accounting* reasons, for purposes of *show*, but not for actual business reasons.

I was once researching a Chinese company (okay, I guess that was the first red flag) with a dream business model. Basically, they were granted prime downtown land by the Chinese government (underground of downtown, but in high foot traffic areas) for free, which they were able to develop into shopping malls, as long as they also made them into bomb shelters for China to use whenever needed. They would sell 20% of the space to finance the costs of building out the shelter and mall, and lease the remaining 80%. It was a capital-lite business with dream metrics. There were a couple of things that disturbed me with the company, but what really turned me off was when they announced a complex deal involving selling one of their properties in full, which was not supposed to be their business model. On further scrutiny, payment was deferred, with the mall as security. Which means the deal did not actually insulate the company from any of the risk of finding tenants and leases performing! I refused to invest in the company, despite its looking so good on paper. A few years later, I saw the company on a list of Chinese companies flagged by Moody's as having red flags pointing to fraud.

Constant one-time charges and fantasy metrics

Every quarter, another excuse is given for why things didn't pan out as expected. They start to get into more inventive versions of the dog ate their homework. Sometimes constant excuses are just a sign of rank incompetence, and sometimes something more sinister is at play. Either situation calls for staying away. A

similar role is often played by fantasy metrics which the company likes to focus on instead of on actual measurable business results. Even worse, when the fantasy metric they point to is changing each quarter to whatever they can tout that particular time as looking good. Red flag.

Narrative

Overly promotional

I like it when companies communicate to investors, customers, and the world what is happening with the company. But if a company is overly promotional, constantly press releasing each small deal and piece of business, this can be a bad sign. They get inventive here — press release that they bid for the contract, press release that they are being considered for the contract, press release that they have reached final stage consideration. Of course, the contract is never mentioned again. It varies by the size of the company (smaller companies are naturally more promotional and should be) and culture (country by country). But at the very least, it shows a focus on something other than running the business. Red flag.

Buzzwords

Closely related to the above is the overuse of buzzwords. Somehow, the same companies that a few years ago managed to work "blockchain" into every conference call and press release have now pivoted to "AI". Look, if the company happens to be legitimately in the AI business, I do not begrudge them talking about it; obviously, it would be weird if Nvidia managed to get through a conference call without discussing the future of AI and their position in it. The companies that are tangentially related at best but trying to jump on the latest bandwagon? Red flag.

Sudden strategy shifts

If the company has sudden unexplained shifts in strategy every few years (often accompanied by a change in name and/or ticker symbol), that is usually the company trying to erase their past history and start fresh. In a legitimate turnaround situation this can make sense, but how many times can this occur in one company? Certainly not every few years with no apparent catalyst. Red flag.

Conclusion

This list of red flags for fraud is not meant to be fully comprehensive, but we do think that we've encapsulated the most common leading indicators that can point to the possibility of fraud in advance of its general discovery. We believe that by paying careful attention to these indicators and not simply assuming good faith on the part of management, an investor can greatly increase his chances of sidestepping these disasters and ultimately greatly improve his long term returns.