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How to Spot Corporate Shenanigans

Whether you are a job candidate, a supplier , or a buyer why would you allow your reputation to be linked to shenanigan prone companies?

Shenanigans refer to corporate practices that may be legal but come close to the line.

What Types of Companies Are Susceptible to Shenanigans?

Howard Schilit, president of the Center for Financial Research and Analysis in Washington, D.C., has identified some warning signs for the company prone to engage in shenanigans. Below are some of his signs plus some of ours. A company with one warning sign does not automatically mean you are dealing with a shenanigan prone company. The more signs you see, the more you should be concerned. We also provide specific questions to ask.

1.

Weak Controls. Are there control systems in place to insure control over how money is spent? One question to ask would be: "If there is a board of directors, tell me about the qualifications of the people on the Audit Committee?" Private companies are not required to have qualified, competent external members of the Audit Committee. External Board members who are friends of the CEO is not a good sign. Ask, "Tell me about the Board" and listen to words like "spirited debate" versus "everybody gets along."

A related controls question would be, "Tell me about the General Counsel?" You want to hear words like "respect" and "integrity."

2.

CEO Personality. Is there a history of the CEO running companies with sudden business reversals? These reversals can be from bad to good or good to bad. It could be that the individual used fraud as a way of triggering the reversal and then bailing out. You can begin to get the answers to these questions by getting a Dunn & Bradstreet credit report. Reports can be purchased at www.dnb.com.

CEOs who tend to focus much of the topic on themselves, have offices that look like dens in their home, have pictures of themselves with famous people, and wear obviously expensive jewelry are behavioral signs that this is a narcissistic individual. Narcissistic people may be quiet or loud personalities. You don't want to be that close to such people.

In a recruitment situation, if the CEO talks about the ineffective people in the company and "you" are going to make all the difference, that is not a good sign easy. Ask others about the turnover rates.

3.

CFO Personality. Ask, "Tell me about the CFO?" You want to hear words like "competent," "forceful," "honest" or "integrity."

4.

Narrow Base for Success. Is the company overly dependent on one or two individuals? Is the company too dependent on one or two product line? Is the company overly dependent on one or two customers? Questions to ask might include, "What is the most important product as a percentage of total sales revenue?" and "Who is the most important rainmaker? Why is this person the most important rainmaker? Tell me about this person."

5.

Compensation System. Does the bonus system create a dangerous short-term focus on quarterly or half year results? If venture capitalists are on the board, get a sense for how long they have invested in the company and how impatient they are they for a liquidity event. The presence on the board of three or more venture capitalists from three different firms can force a dangerous short-term perspective.

6.

Convoluted Financial Structure. In a private company, examine the Dunn & Bradstreet credit report. In a public company, look at the 10Ks. Is the company's financial and legal structure overly complex for its size and industry? If so, it might be possible to hide shenanigans through untraceable patterns of intercompany borrowing. Are there special covenants with investors and creditors that might give them more influence over business operations than is customary? If you are not sure, ask in the interview about the number of corporate entities that operate within the structure.

7.

Profits Out of Line. Unusual profits relative to industry standards may indicate a well-run company. It may also point to accounting gimmicks, such as shifting expenses to next year. Go to your local commercial bank to browse through the RMA Directory. Published by the Risk Management Association (www.rmahq.org), RMA has summaries of 350,000 financial statements broken into SIC code and sales size. Using RMA allows you to make specific comparisons between your target company and a larger index based on sales volume and industry grouping.

8.

Shifting Consultants. Look for recent switching of consultants and other vendors as a diagnostic sign. Examples would involve recent switching of banks, CPAs, or law firms. The question to ask would be, "How long has the company had its relationship with its present outside legal counsel, bank and CPA firm?"

Forewarned Is Forearmed

President Ronald Regan once quoted a Russian proverb that makes sense for anyone thinking about putting their reputation in the hands of others: trust but verify.

Maryanne Peabody & Larry Stybel are co-founders of Stybel Peabody Lincolnshire. Founded in 1979, its mission is smooth leadership change when the stakes are high. Core services include retained search with a focus on Boards and CEOs, executive level outplacement, and high potential leadership coaching. Their website is www.stybelpeabody.com.