A GUIDE TO THE FINANCIAL RISKS OF FREIGHT PAYMENT PROVIDERS

www.a3freightpayment.com

A GUIDE TO THE FINANCIAL RISKS OF FREIGHT PAYMENT PROVIDERS

Introduction

The selection of a freight payment company involves more than just hiring a service provider. It means selecting a custodian for millions of dollars of a company's assets. The freight payment company is being called upon to be a "good steward" of assets to which it has no claim. This paper focuses upon the clarification of what a customer should and should not consider when evaluating a freight payment company's role as a fiduciary, and potential financial risks.

Audited Financial Statements

A freight payment company that will not produce audited financial statements for its customers' review should be automatically eliminated from consideration during a freight payment bid process.

Audited financial statements are the lynchpin of any financial due diligence over a potential freight payment provider

Audited financial statements are the lynchpin of any financial due diligence over a potential freight payment provider. The audited financial statements provide several key insights into the potential provider, which cannot be garnered from any other source.

First, audited financial statements show the general financial health of a freight payment company. This is important to a customer even if the customer is not utilizing the processor for payment of invoices. A financially unstable freight payment company poses an operational risk to all customers. What if the freight payment company just goes out of business with minimal warning? A financially unstable freight payment company could also be tempted to use freight funds or refunds (see discussion below) to cover its operating losses instead of paying freight bills. Finally, a consolidated set of financial statements brings clarity to a user as to whether the freight payment company is engaged in other businesses, which could be draining cash (see the Computrex case).

Secondly, a set of audited financial statements provides a customer with assurance that the freight payment company has an internal control structure that can be relied upon. As part of a standard audit of financial statements, the independent auditor will test the basic control structure of the provider. The results of those tests will tell the auditor if the control structure can be relied upon in the preparation of the financial statements. If the control structure cannot be relied upon and additional testing does not give the auditor comfort, the financial statements will not have an auditor's opinion. Rather, they will have something called a "disclaimed" opinion.

The vast majority of public accounting firms can perform a high quality financial statement audit. A little due diligence by a customer regarding the accounting firm might be important for a customer if he wishes to ensure that the auditor is strong enough to conduct a thorough examination. However, the rules around audit engagements are extremely strict. A public accounting firm rendering an audit opinion has to comply with the same set of standards regardless if they are a "Big Four" or a regional firm. Further, all firms engaged in such attestation work are subject to strict "peer reviews" to ensure continuing quality of work.

According to Sarbanes-Oxley, those customers who outsource freight invoice processing remain responsible for the internal controls over the processing of freight invoices

Once again, the absence of a freight payment company's commitment to provide audited financial statements should be a disqualifying factor in your selection of a freight payment provider.

SOC 1 or SSAE 16 (Formerly SAS 70)

A Service Organization Controls Report #1 or "SOC 1" report is issued by an independent auditor who reviews the internal control structure of a service organization (freight payment company). The report is for the exclusive use of user organizations (customers and prospective customers of a freight payment company).

The auditor who performs the examination and issues a SOC 1 report uses a set of standards known as the Statement of Standards for Attestation Engagements (SSAE) No. 16. This standard replaced SAS 70. A freight payment customer might be more familiar with the term SAS 70 when referring to such reports. For a customer, the differences between an SOC 1 report and the old SAS 70 report are minimal (Schellman, 2010).

The SOC 1 report is of particular value to those organizations subject to the internal control reporting mandates of Sarbanes-Oxley. The accurate reporting of freight expense is a significant item on the financial statements of freight payment customers. According to Sarbanes-Oxley, those customers who outsource freight invoice processing remain responsible for the internal controls over the processing of freight invoices—they cannot outsource internal control. So, how does a customer meet these responsibilities?

The SOC 1 report is meant to demonstrate that a customer does have visibility over the outsourcer's control structure and has done a proper review upon it. Although the report does not "check the box" for Sarbanes-Oxley in and of itself, it gets a customer far along the road to compliance.

Beware... The SOC 1 Does Not Speak to Financial Viability

The SOC 1 report can provide great insight into a freight payment company's internal control structure but it does not guarantee financial viability of the company. The SOC 1 examination does not detect fraud, and makes absolutely no judgments as to the ability of the freight payment company to continue as a going-concern.

The SOC 1 report is one of several items that a customer should consider when evaluating a freight payment company's role as a fiduciary, but it should not be the sole factor evaluated.

A3 Freight Payment will soon be offering a complete white paper on the SOC 1 report entitled: The Role of a SOC 1 Report (formerly a SAS 70) in a Freight Payment Relationship.

EFTs vs. Paper Checks

A freight payment company that is intent upon serving a client's needs will employ an aggressive program to pay carriers by means of Electronic Funds Transfers (EFTs). The company will avoid paper checks and encourage carriers to accept EFTs. A large proportion of paper checks could be a warning sign that a freight payment company does not completely embrace its fiduciary role.

Paper checks take time to reach their destination through the mail before they become "good funds" in the account of the payee. During this time, the freight payment company can earn interest from those funds. This time is called mail float. Once the checks are deposited into the bank, they take a day or so to be removed from the account of the freight payment company. This time is called Fed float and is also an opportunity to earn interest.

The kiting of payments was a hallmark of all of the major cases of fraud in freight payment

With interest rates at record lows, the potential earnings from float available to freight payment companies are very limited, at present.

However, the prevalence of check-based payments at a provider could point to a much more sinister situation. In cases of fraud where a freight payment company may be "kiting" checks (using new deposits to cover old checks), the mail float and fed float provide valuable time to keep the shortfall invisible and allow such a scheme to continue. The kiting of payments was a hallmark of all of the major cases of fraud in freight payment during the early 2000s, including both the STI and Computrex cases (Boyce, 2003). These companies used check payments as a way to hide the fact that they had stolen freight funds to cover operating losses of the business and/or its subsidiaries and affiliates.

An aggressive EFT program is the mark of a solid provider willing to embrace its role of providing best-in-class payment features to its customers.

Refunds

In the normal course of a freight payment relationship, a freight payment company will receive refunds from logistics providers on behalf of its customers. The refunds are sent to the freight payment company because it is designated in the "Bill To" section of the carrier's system. That is typically the destination used by the carriers for sending refunds.

These refunds are triggered for many different reasons. They can be due to duplicate payment of an invoice by both the shipper and consignee. They can be due to cancelled shipments, which were accurately invoiced and paid before cancellation could be communicated. They can even be for something like COD amounts for merchandise paid by the recipient of a shipment. Regardless of the reason, refunds do occur, and a best-in-class freight payment company must have a solid process for their handling.

Refunds provide a double-negative incentive to a freight payment company. First, they are a cost driver to the company in terms of needing to process the refunds. Second, they are almost completely invisible to shippers. If a shipper does not know that a refund is due, he is not anticipating it. So, if a refund should fail to arrive from the freight payment company to the shipper, he would be none the wiser. Consequently, the freight payment company has two incentives to not process refunds efficiently... they are costly, and no one is watching.

> *Consequently, the freight payment company has two incentives to not process refunds efficiently... they are costly and no one is watching*

The A3 Freight Payment process receives refunds and immediately deposits them into a Freight Payment Trust account. The refunds are identified as belonging to specific customers and the credit for them appears as unapplied cash for the customers. An aging report is produced to support the items.

Further, the customer's database is properly credited for the refunds with the proper accounting codes. This allows the customer the ability to properly account for his freight and logistics spend net of any refunds. If a particular refund is tied to a given invoice, such linkage is made in the database.

Refunds are also an excellent source of feedback information for the provider in improving the freight payment process. Reasons for refunds are tracked by account management personnel, and with this data, process changes can be made to eliminate the source of the refunds and provide a more reliable process to the customer.

A3 Freight Payment clients are refunded by means of a netting process. The client's weekly Freight Funds Request will reflect any credits granted for received refunds. The client will then issue a net funding which takes such credit into account.

Customers of freight payment companies would be wise to have themselves named as "loss payees" on the employee dishonesty policy

Refunds are a fact of life within the freight payment process. A provider that does not have a strong control structure for refunds creates potential exposure for lost or misapplied funds for its customers. The refund process should always be part of the due diligence review of a prospective freight payment company.

Employee Dishonesty Insurance

In receiving temporary custody of a customer's assets, freight payment companies are assuming a risk of safekeeping, against which they normally take insurance. The insurance coverage can go by many names. It can be called a fidelity bond, a crime policy, or employee dishonesty bond or employee dishonesty insurance. Employee Dishonesty Insurance is the most descriptive term and, therefore, is how A3 Freight Payment refers to it.

Employee Dishonesty Insurance protects the freight payment company (not its customers) against losses incurred due to the dishonest acts of its own employees. If employee John Smith of the freight payment company steals $1 million and heads to Bermuda, the freight payment company claims the loss with the insurance company. The insurance company makes the freight payment company whole and then tracks down John Smith for recovery.

Customers of freight payment companies would be wise to have themselves named as "loss payees" on the employee dishonesty policy. In the event that an employee steals the assets of that customer, the customer may go directly to the insurance company and be made whole for his loss without needing to go through the freight payment company. This is important should the freight payment company go out of business due to the loss. The "loss payee" standing allows the customer to avoid the bankruptcy court.

Some employee dishonesty policies also cover criminal acts of third parties who are not employees. They can cover such things as electronic fraud where EFT systems are hacked and a customer's money is stolen, as well as acts of forgery by third parties.

Customers of freight payment companies should require a certificate of insurance issued in their name to be sent to their risk management personnel or other representative. A copy of a "generic" certificate is not evidence of coverage. It must have the customer's name and address on it and should come directly from the insurance company or broker. It should NOT come from the freight payment company (Risk Management, UC Santa Barbara, 2004).

Employee Dishonesty Insurance is NOT a surety bond. A surety bond is inappropriate for a freight payment company. It is typically used in the case of a contractor where one wishes to make sure a building job is completed even if the contractor goes out of business. These are extremely expensive bonds and the provider's lack of an insurable interest (e.g. a construction project) usually makes them inaccessible for freight payment companies.

...the assets of the fund cannot be seized by creditors of A3 Freight Payment LLC

The A3 Freight Payment Fund

The A3 Freight Payment Fund is the centerpiece of the A3 Freight Payment fiduciary control structure and is a unique innovation in the freight payment marketplace. The A3 Freight Payment Fund is a bankruptcy-remote, fully audited Special Purpose Entity (SPE) established for the exclusive purpose of providing A3 Freight Payment's clients with the highest degree of confidence in the company's financial strength and payment capabilities.

The fund is bankruptcy-remote, meaning that in the incredibly unlikely event of the financial failure of A3 Freight Payment LLC, the assets of the fund cannot be seized by creditors of A3 Freight Payment LLC. The assets remain safe and ready for the payment of freight invoices.

The A3 Freight Payment Fund is audited each year by an independent accounting firm. This audit provides clients with the assurance that the assets and liabilities of the trust are properly valued and that all funds necessary for the settlement of freight transactions are present and ready for that purpose.

For a full discussion of the benefits of the A3 Freight Payment Fund please see our soon-to-be-published white paper on the fund.

Reconciliation and Aging

Due to the sheer volume of transactions that the treasury system of a freight payment company processes, a control and reporting system of the highest caliber is essential.

A freight payment company should be able to provide its customers with a detailed report of all funds on deposit with the provider and the age of those deposited funds. This is especially important for the tracking of unapplied cash receipts.

Many freight payment companies have seen growth into large transactional volumes over time. The challenge lies in whether their treasury and reconciliation systems can keep pace with this growth. Timely and accurate reconciliation of the assets (cash) and liabilities associated with freight funds at a freight payment company is critical to the operational control of the company.

A3 Freight Payment's systems were built to handle large transaction volumes and have the reconciliation and aging reporting systems online to handle these challenges

A3 Freight Payment's systems were built to handle large transaction volumes and have the reconciliation and aging reporting systems online to handle these challenges.

This is also an instance where the value of audited financial statements is seen. Audited statements which include the assets and liabilities associated with freight funds transactions will compel the independent accounting firm to place a high degree of scrutiny upon the freight funds accounts.

D&B Report Does Not Matter

At one time Dun and Bradstreet (D&B) was THE standard in trade credit reporting. They provided accurate and practical information to sellers who wanted to make a decision regarding whether or not to grant trade credit, and in what amount, to a potential customer. D&B's business model has undergone some dramatic changes and one can legitimately question if a D&B report is useful in selecting a freight payment provider, if it ever was.

As noted above, D&B's purpose is to provide data to make the decision on granting trade credit. Freight Payment is not a trade credit relationship. The dollar amounts are much larger and the processes of freight payment make it difficult to make an apples-to-apples comparison to a trade credit candidate.

In essence, a freight payment customer is not establishing a credit relationship but more of a custody relationship whereby they are entrusting their assets to the custody of the freight payment company. It is more akin to the relationship between a shipper and a public warehouse. Consequently, a shipper is more concerned about safety, security, and good processes rather than whether the freight payment company can pay its light bill on time.

That being said, a financially "unhealthy" freight payment company could be a risk in that they would be tempted to use freight cash for something other than paying the shipper's freight invoices. This risk can be mitigated by the special purpose entity structure whose financials and controls are audited. (See the A3 Freight Payment Fund, above.)

A freight payment company could be a great credit risk but show a horrible payment history due to the bad processes of its customers

Payment history is another aspect of D&B's data whose use in evaluating freight payment companies is suspect. A freight payment company could be a great credit risk but show a horrible payment history due to the bad processes of its customers. Since freight payment companies are listed as the "bill to" at the carriers, the payment history of its customers can be reported as its own. Therefore, bad customer payment processes can disrupt the freight payment company's payment history and make them appear to be a slow payer.

Their Bank's Financial Statements Do Not Matter

A very "old school" response to the question of financial stability has been for a freight payment company to withhold its own financial statements and, instead, provide the financial statements of its bank. The freight payment company explains that they provide the financial statements of the bank because "that is where your money is." Most shippers understand the logical fallacy.

There have been many a bankrupt company and/or nefarious enterprise which had an account at a healthy bank. A healthy bank does not provide a shipper with any risk mitigation. Rather, the providing of a bank's financial statements becomes a "distractor" intended to "check the box" of providing audited financial statements.

There is no substitute for the audited financial statements of the provider. They provide clear visibility to the status of the provider's health and internal control structure.

The Fallacy of "We Are a Bank"

Some freight payment providers are operated by financial institutions. There are a few misunderstandings with regard to the perceived added security of funds that might be afforded by having a bank handle freight payment.

The first fallacy to which shippers fall victim is assuming that their funds are FDIC insured. They are not. The financial institutions that provide freight payment services intentionally do not characterize their freight funds on deposit from customers as deposit accounts and, therefore, they are exempt from FDIC coverage. This allows the financial institutions to not pay FDIC insurance premiums on these funds, thus, saving the financial institutions costs and improving their margins.

The next fallacy is that financial institutions have a larger regulatory burden than other types of freight payment companies and, therefore, are more secure. While financial institutions do have higher compliance costs and compliance procedures to follow, this is not a guarantee against institutional failure. Since 2007, some 538 financial institutions have failed (IEHI, Inc., 2012). In addition to the failures, troubled financial institutions have incurred nearly $1 trillion in write-downs and other capital impairments due to bad business practices.

The financial institutions that provide freight payment services intentionally do not characterize their freight funds on deposit from customers as deposit accounts and, therefore, they are exempt from FDIC coverage

Further, freight payment is a unique animal in the banking world. Freight transactions have extremely large data structures, and transactional volumes are unlike any other process in the world of banking. This level of complexity makes it a challenge for any external bank auditor to fully understand. Bank auditors are used to Aunt Melba's checking account with 20 transactions per month as opposed to a freight payment account with 50,000 LTL invoices. Therefore, in the unlikely event that something goes wrong with a bank-based freight payment company's processing platform, it will be challenging for an auditor to detect. They just don't have that experience.

Finally, the major bank players in freight payment do not pursue a "traditional" banking model with freight funds. In one case, they use shippers' credit to rapidly pay invoices to carrier, and deduct a fee much like a credit card company. In another case, a bank builds a portfolio of "non-traditional" loans with the freight funds on deposit by lending money to churches and other houses of worship, a niche credit market to say the least.

Although bank-based freight payment companies offer a measure of potential security, they are not a "panacea" to the issues of financial stability.

Longevity in Business Does Not Matter

It may not bear pointing out, but longevity in business is a woefully inadequate indication of financial health. Bernard Madoff's Ponzi scheme lasted for over 36 years before the size and extent of the loss was revealed (Henriques, 2008), and could have continued even longer. Additionally, many of the companies in the freight payment industry that have gone bankrupt were, themselves, in business for a decade or longer before the "day of reckoning" arrived (Boyce, 2003).

Longevity in business is a woefully inadequate indication of financial stability

Longevity in business is a inadequate indication of financial stability. A customer's due diligence must go beyond just seeing the "born on" date of a freight payment company.

Rapid Pay Programs Are a Red Flag

Years ago, one of the larger players in the freight payment industry pioneered a scheme to use the credit of shippers to pay carriers rapidly and receive a fee for doing so. The fee was usually around 1% of the invoice value. The shipper would then pay the freight payment provider on normal terms (net 30). This was an extremely profitable scheme for the provider. However, it has its limitations and operational downsides. But, this piece will not explore those.

Other freight payment companies have tried to replicate this rapid pay process. These "copy cats" have seen anything from limited success to colossal failure.

Rapid pay programs are extremely complex systems demanding a very sound method for tracking transactions and for evaluating the credit of the shippers. The process of underwriting the credit risk of the shipper is extremely important, and if done wrong can lead to the failure of such a program.

The process of underwriting the credit risk of the shipper is extremely important, and if done wrong can lead to the failure of such a program

The profitability of a rapid pay program can be wiped out with one customer's financial failure. Worse, if the freight payment company does not have the capital to absorb the credit loss, it could turn to other customers' freight funds to cover it.

Finally, the transaction flows for rapid pay programs are very complex.

They require monitoring of not only funds on deposit, but also the available credit of a given buyer and its transactions which have and have not been funded. This credit relationship makes the already complex funds flow model of freight payment companies even more so. And, where there is complexity, there is the potential for systemic failures that can product real financial losses.

Rapid pay programs should be seen as a "red flag" to a freight payment customer. They can be positioned by a provider as a way to get freight payment done at "no cost". But, as generations of businesspersons have learned, there is no free lunch. A "free" solution such as this comes with hidden costs and carries a world of financial and operational risks to the freight payment company and, by extension, to their customers.

Conclusion

No one thing can be done to immediately eliminate all risks associated with a freight payment provider's fiduciary role. But a diligent customer can mitigate the vast majority of risk by taking a few steps that were mentioned within this guide.

A3 Freight Payment

A3 Freight Payment provides managed, customized freight payment solutions to large volume shippers. The company has developed and utilizes a robust system that brings shippers the highest degree of transparency, customization, and processing control found anywhere in the freight payment industry.

A3 Freight Payment is a nationwide provider and is headquartered in Memphis, Tennessee. For more information, visit www.a3freightpayment.com

Dos and Don'ts for Financial Due Diligence on Freight Payment Companies

DO:

- *Review audited financial statements*
- *Review an SOC 1 report*
- *Investigate the refunds process*
- *Insist that company assets are "bankruptcy remote" from the freight payment companies*

DON'T:

- *Count on longevity in business*
- *Believe that a bank-based solution solves all issues... funds are not FDIC-insured*
- *Accept the financial statement of the company's bank, instead of its own*
- *Rely upon a D&B report to provide meaningful information*

Works Cited

Boyce, C. (2003, March 3). STI Insolvent Since '93. Retrieved June 1, 2012, from *Journal of Commerce*: http://www.joc.com/logistics-economy/sti-insolvent-93

Henriques, D. B. (2008, December 12). For Investors, Trust Lost, and Money Too. The *New York Times*, pp. http://www.nytimes.com/2008/12/13/business/13investors.html?_r=1&adxnnl=1&pagewanted=all&adxnnlx=1339084889-kXIoEHXBeiExvfUXyqE/Ow.

IEHI, Inc. (2012, June 6). Home Page. Retrieved June 7, 2012, from The Bank Implode-O-Meter: http://www.bankimplode.com

Risk Management, UC Santa Barbara. (2004, April). Quick Tips: Understandign the Accord Certificate of Insurance. Retrieved June 1, 2012, from http://www.busserv.ucsb.edu/Forms/rm/quicktips/QTAcordCert.pdf

Schellman, C. (2010, May 20). 5 Things You Should Know about SSAE 16. Retrieved May 30, 2012, from *Accounting Today*: http://www.accountingtoday.com/news/5-Things-You-Should-Know-About-SSAE-16-54292-1.html

A3 Freight Payment
8700 W Trail Lake Drive, Suite 100
Memphis, TN 38125
Tel: 901-759-2966
Fax: 901-759-2966
info@a3freightpayment.com
www.a3freightpayment.com

Published 7/12