Financial (Mis)Statement Fraud – A walk down memory lane

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Financial (Mis)Statement Fraud

Definition

Australian Auditing Standard ASA 240

“Fraud means an intentional act, by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”

National Commission on Fraudulent Reporting (Tredway 1987)

“The intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision’

Common financial statement fraud schemes

- falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions;
- material intentional omission or misrepresentations of events, transactions, accounts, or other significant information from which financial statements are prepared;
- deliberate misapplication of accounting principles, policies, and procedures used to measure, recognise, report, and disclose economic events and business transactions; and
- intentional omissions of disclosures or presentation of inadequate disclosures regarding accounting principles and policies in addition to related financial accounts.

(Rezaee, 2010)

Why do we care about it?

- Investor confidence
- Usually masking something else (within the business)
- Financier reliance
- Could be covering up another underlying fraud
- Company failures – Insolvency
- It is fraud after all!

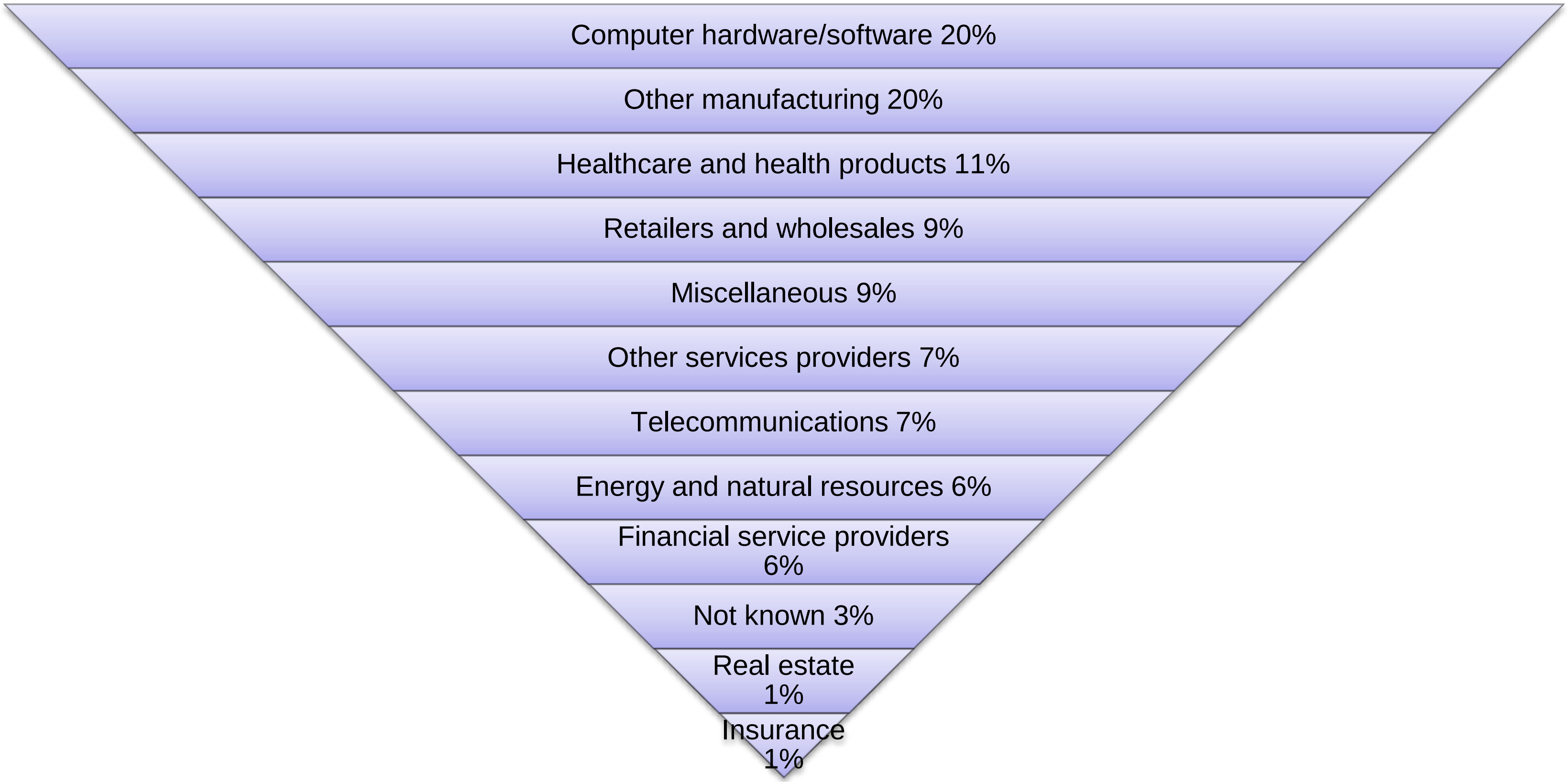
COSO report into frauds in USA public companies 1999-2007

Key findings:

- 347 cases of public company fraudulent financial reporting
- total cumulative misstatement or misappropriation of nearly $120billion across 300 fraud cases
- $400million per case
- CEO or CFO involved in 89% of the fraud cases
- The most common techniques involved improper revenue recognition, overstatement of existing assets and capitalisation of expenses.
- Revenue frauds accounted for over 60% of the cases.

COSO Report, 2010

Primary industries of sample fraud companies:



When motive combines with opportunity

- meet external earnings expectations of analysts and others
- meet internally set financial targets or make the company look better
- conceal the company's deteriorating financial condition
- maintain or increase share price
- bolster financial position for pending equity or debt financing or to obtain credit based on misleading financial statements
- hide improper business transactions (eg. Fictitious sales or misrepresented assets);
- resolving temporary financial difficulties (eg. Insufficient cash flow, unfavourable business decisions, maintaining prestige)
- Desire to minimise tax liabilities;
- Need to avoid breaches of debt covenants;

(Rezaee, 2010)

Personal motivation

- increased compensation through higher reported earnings
- enhanced value of personal holding of company stock, such as stock-based compensation
- converting the company’s assets for personal use;
- obtaining a promotion or maintaining the current position within the company.
- cover up assets misappropriated for personal gain.

Common Fraud Schemes

- misclassification of gains
- Sham transactions
- Timing of revenue recognition
- Bill and hold sales transactions
- Side arrangements
- Illegitimate sales transactions
- Improper revenue recognition
- Improper related-party transactions
- Improper asset valuations
- Improper deferral of costs and expenses
- Inadequate disclosure or omission of material financial information

Accounting Scandals

- ZZZZ Best Carpet Cleaning
- Waste Management
- Enron
- WorldCom
- Adelphia
- Phar-Mor
- One.Tel
- HIH
- Centro
- Harris Scarfe
- Hastie

Accounting Scandals
ZZZZ Best Carpet Cleaning Co (1986)

- Started ZZZZ Best at age 15 in his parents' garage
- Company went public in 1986
- Reached market capitalisation of $200million
- Millionaire by 18
- 90% of the business was non-existent
- Never made a profit
- Diversified by creating a fake 'restoration company' and winning industry leading contracts
- Deceived auditors and lawyers – rented buildings, bribed security guards, manufactured 16,000 documents in one year
- Ponzi scheme
- 90% of reported revenues based on non-existent contracts
- Bankrupt, in gaol by 21, assets sold for $50,000

Accounting Scandals
ZZZZ Best Carpet Cleaning Co. continued

- Unpacking the facts – the red flags were clear:
  - Rapidly growing profit was inconsistent with industry standards
    - $13.8million restoration contracts on two buildings
    - Previous record restoration known in industry was $2.1million
  - Doubtful trends
    - Revenue to expense ration outside norm
    - Payroll much lower than industry standard
  - Vague documentation of contracts
    - 1 page
    - Missing key terms
  - Questionable management integrity
    - Organised crime associates
    - Money laundering, credit card fraud

Accounting Scandals
ZZZZ Best

	1985	1986
Current ratio	36.55	0.10
Working capital: total assets	0.59	(0.0080)
Collection ratio	N/A	26.13
Asset turnover	0.14	1.04
Debt to equity ratio	0.02	1.49
Receivables turnover	N/A	6.98
Times interest earned	N/A	43.14
Cost of sales: Sales	0.47	0.42
Gross margin	53.51%	57.68%
Return on equity	183.75%	46.58%

Waste Management (1997)

- Largest restatement of fraudulent earnings reported in USA history
- New CEO quit after 3 months of commencement – prompting analysis
- November 1997 company announced that a change in accounting methods would result in $1.2billion loss and reduce retained earnings by $1billion
- In 1992 auditors found evidence of misstatements of $93.5million
- Company refused to restate to correct mistake
- In 1993 auditors documented another $138million misstatement – would have reduced income by 12% - not material
- In 1995 auditors documented another $160million misstatements as immaterial
- between 1992-1996 engaged in $1.4billion financial statement fraud

Waste Management continued

- Who?
  - Top management, CFO, chief accounting officer
  - Collusion with 4 Arthur Andersen partners
- How?
  - Overstatement of earnings and ‘hidden’ expenses
- Why?
  - Pressure to meet earnings expectations
  - Auditors desire to keep client ‘happy’

Every CFO and chief accounting officer had previously worked as an auditor at Arthur Andersen…

Enron (2001)

- Seventh largest corporation in USA. 21,000 employees, 40 countries
- Off balance sheet partnerships and special purpose entities hid $BILLIONS of losses
- Complex operating structure
- Board did not understand the transactions – didn’t ask for more information
- Enron employed 3 primary accounting ‘shenanigans’
  - Mark to model accounting
  - Use of off-balance sheet SPE’s and related entities
  - Sale of company shares treated as accounts receivables
- Stock fell from $80 in January 2001 to $0.25 in December 2001 ($80billion in market capitalisation lost)

Enron continued

- Mark to model accounting
  - Derivative not reported at historical cost – reported at underlying 'fair market value'
  - No market = make it up
  - Doubtful that some underlying assets existed
  - Estimated future earnings re-estimated each year
  - Active markets didn't exist
  - Enron controlled the estimation of earnings
  - Executive compensation based on earnings
  - Had to report losses when market turned … SPE's created to 'fix' this reporting problem!

Enron … continued

- Use of off-balance sheet SPEs
  - Enron a market maker BUT took an ownership position in assets traded
  - Ownership created enormous debt
  - Well over 500 SPEs (some reports say 3,000) and thousands of questionable partnerships
  - CFO made $30million off SPEs, assistant made $12million
- Sale of shares treated as accounts receivable
  - Enron issued own shares in exchange for notes receivable in 4 SPEs
  - Increased notes receivable (asset) and shareholder’s equity to record transactions
  - Should have been presented as deduction from shareholder’s equity – GAAP
  - $1 billion between June 2000 and March 2001

WorldCom (2002)

- Whistle-blower (Cooper) - largest corporate fraud in US history - $11billion
- Internal audit investigated the reliability and integrity of financial info
- $2million spent on ‘capital expenditure’ without documented approval
- Expenditure really for lease costs – line rental fees
- $500million in undocumented computer expenses
- Financial controlled admitted shenanigans
- 1998-2000 = reduced reserve accounts adding $2.8billion to revenue
- Late 2000 = operating costs capitalised as long term investments $3.85billion
- $9billion adjustment for 1999- first quarter 2002

Adelphia (2002)

- Largest cable television and telecommunications provider in USA
- Following Enron collapse, SEC provided guidance re disclosures of related party transactions
- Adelphia disclosed – share price dropped from $30 (Jan 2002) to $0.30 (June 2002)
- Co-borrowed with Rigas family entities, $1billion in 1999 (x3 in 2000)
- 1999-2001 fraudulently excluded from annual and quarterly financial statement over $2.3billion in bank debt by shifting liabilities off-balance sheet
- Sham accounting transactions, fictitious documents saying Adelphia had repaid debts although they just had been ‘shifted’ off-balance sheet
- 1998 onwards – fraudulent misrepresentations, omissions of material facts to conceal extensive self-dealing by controlling family
- 15 (CEO) and 20 (CFO) years in prison

Phar-Mor

- ‘temporarily’ parked losses
- Hid losses in inventory
- Operating losses spread across 40 stores and various products
- Declared record profits
- Received $200million investment – used to pay creditors
- No profit in fact ever made
- $500million fraud over 4 year period
- Chapter 11 bankruptcy

HIH (2001)

- Tip: know the industry you are investigating or valuing
- Reinsurance: if provisions were understated, profit was overstated
- If provisions were overstated, profit was understated – incentive!
- Under provisioning can overstate solvency in the balance sheet
- HIH applied a method other than industry practice, therefore creating an overly optimistic view of claims provision, but continually overstated earnings
- Alleged that HIH/FAI chose a profit target number then altered the provision to arrive at that figure
- Purpose of reinsurance was to transfer risk to the reinsurer ….
  - Side letters
  - Backdating documents

HIH …

‘The word “audacious” springs to mind’

Owen J

One.Tel (2001)

- Record result announced September 1999 - $6.97million
- Filed accounts showed change in accounting treatment increase results by $50million
- Profit came from purchase of a tax benefit
- Capitalised $32.4 in start up costs (advertising and staff costs as an assets rather than writing off as an expense)
- ASIC required restatement - $245million previously hidden, declared in 2000
- Multi-million dollar bonuses paid to Rich and Keeling hidden from public scrutiny by questionable accounting practices
- Bonus paid in 1999 treated the payments as set up costs
- Recognised revenues ahead of the likely related cash flows
- Grossly overstated debtor balances
- Effectively converted a loss into a profit

Harris Scarfe (2001)

- Inflates value of assets acquired when Harris Scarfe bought retail stores
- “artificial value” would then be used to reduce expenses which had the effect of lifting the groups profit by millions of dollars each year
- CFO (Hodgson) increased accounts by $36million to obtain a $67million loan and $37million from the issue of new capital
- CFO declared to board that results overstated, materially fictitious
- Consolidated statement for y/e December 2000 overstated group net assets.
- Inventory deliberately stated at artificially high levels
- Inappropriate accounting methods for classes of assets
- Liabilities understated
- Accountants were running two sets of books – not picked up by auditors
- Falsifying accounts to create a false picture
- CFO authorised accounts to be changed on cue if certain profit result was required by managing director or chairman
- CFO Jailed for 6 years

Centro Properties Group (2008)

- ASIC queried the 30 June 2007 financial accounts as the current debt levels were recorded at $0
- Centro had classified all interest-bearing liabilities as non-current
- Restated accounts - $1.096billion of short term debt from non-current to current
- Second restatement in February 2008 – increase current liabilities to $2.61billion
- The 2007 ‘error’ avoided Centro being considered unable to pay its short terms debt of around $450million.
- Share price collapsed, losing about 82% of its value

Hastie (2013)

- $20million
- Book keeper
- No personal profit
- ASX announcement

“no fraud was involved – instead numbers were “fudged” in order to meet profit forecasts”

Prevention

- Mitigate the effects of motive, opportunity and rationalisation
- Will occur if and when benefits outweigh costs
- Understand the reasons
  - Corporate governance
  - Ineffective board of directors
  - Top management attitude
  - Economic conditions
  - Availability of credit

Detection

- Red flags – know what you are looking for … BUT don't jump at shadows
  - Lifestyle and habits
- Look for pressures
- Governance structure
- Oversight function
- Internal control structure
- Profit exceeding industry average profit
- Significant turnover in accounting personnel

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