Financial Statement Fraud
(FSF4)

KAPLAN

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TABLE OF CONTENTS

Unit 1

Introduction

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- Define fraud in the context of financial statement fraud
- Describe examples of fraudulent financial reporting
- Describe management's and auditor's responsibilities in the areas of fraud prevention and detection
- Describe the Fraud Triangle and its implications for financial statement fraud
- Recognize both soft and hard indicators of fraud

TYPES OF FRAUD

While this program is focused primarily on financial statement fraud, we should note that there are various types of fraud. Fraud can be broken out into:

Management Fraud

Management fraud is created by those in management who have better access to company assets and are capable of overriding internal controls. Management fraud is normally of a greater dollar amount than occupational fraud. Management fraud examples include:

- Financial statement fraud
- Misappropriation of corporate assets
- Illegal acts
- Bribery, both paid and received

Management fraud can be designed to overstate business income or understate business income. For example, overstatement may be designed to meet earnings predictions or maintain the price of the company's shares. Management may want to understate earnings when they desire consistent earnings trends over time.

Occupational Fraud

Occupational fraud occurs when opportunities exist for employees to steal company assets due to poor internal controls or inadequate supervision. As we will see later in this seminar, corporate culture as developed by management or management practices often drive the behavior of employees to commit fraud. Occupational fraud examples include:

- Theft of cash, inventory, or other organization assets
- Bribery received, often in the form of kickbacks
- Overstating expense reimbursements

Some authors will include a third category of fraud – corruption. Corruption generally includes bribery, conflicts of interest, illegal acts, or even extortion by third parties. Since this program focuses primarily on financial statement fraud, we will use the two fraud classifications of fraud above – management fraud and occupational fraud.

INTRODUCTION TO FINANCIAL STATEMENT FRAUD

This program is focused primarily on financial statement fraud – types, causes, cases, and consequences. We will also broadly discuss asset misappropriations (customer and employee theft) due to their losses having a significant negative impact on financial reporting results.

Fraud is generally defined as:

> A deliberate false intentional misstatement of a matter of fact – fraudulent financial reporting and misappropriation of assets – whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed, that deceives and is intended to deceive others so that the individual will act upon it to his or her advantage.

The key terms in this definition are deliberate false misstatement, intentional, misappropriation of assets, fraudulent financial reporting, and concealment. Let's look at each term:

- **Deliberate False Misstatement** – Fraud is deliberate, not a mistake, and it is designed to benefit one party while harming another party (company or individual).
- **Fraud is Intentional** – Fraud is planned and it does not happen by accident.
- **Fraudulent Financial Reporting** – Fraudulent financial reporting is preparing false or misleading financial statements. This is normally committed by upper management. Examples include: fictitious revenues, timing differences, hidden liabilities, and expenses, improper asset valuation, or impairment recognition.
- **Misappropriation of Assets** – Fraud can be a theft of assets (cash, inventory, equipment) and when internal controls are poor, theft can be concealed by manipulating the accounting

records. Normally, misappropriation of assets can take place when there is a lack of segregation of duties and weak internal controls.

- **Concealment** – Concealment is deliberate, creating misleading information by using the confidence others have in him/her to hide the fraudulent actions taking place.

In a similar manner, the Association of Certified Fraud Examiners defines fraud as:

> Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent on the application of threat of violence or of physical force. Frauds are perpetrated by individuals and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Also, the AICPA's Auditing Standards Board in AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*, defines fraud as:

> An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement of financial statements that are the subject of an audit.

As we shall see in later sections of this program, **fraudulent red flags** are often present when financial statement fraud occurs. Examples of financial statement fraud red flags include the following:

- Incentive compensation plans linked to performance
- Management dominated by a single individual or a small group
- Management sets unrealistic or aggressive financial goals
- Past history of fraudulent activity or illegal activity
- Unusual one-time transactions recorded during an accounting period

Examples of **fraudulent financial reporting** (potential fraud risks) include:

- Shipping product to a company owned/controlled warehouse – obtain third party shipping documents and create a false bill
- Overstating revenue and income by creating false journal entries that debit assets (inventory or PP&E) and credit revenue
- Use of side agreements between customers or related parties designed to overstate revenues and income
- Understating liabilities and expenses to increase reported income
- Deliberately misapplying accounting principles used to measure and recognize operational activities

- Transferring uncollectible receivables to unconsolidated off-balance sheet entities and not recognizing the losses
- Source documentation supporting transaction activity for customer payments is altered to appear to have come from the customer
- Borrowing monies from third parties and record the borrowings as sales or customer payments
- Use false or improper inputs for significant estimates or fair values
- Establishing unnecessary reserves and reducing these unneeded reserves in later periods through income

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EXAMPLE

Cardinal Health, Inc. is a "Fortune 500" pharmaceutical distribution company. The SEC accused the company of defrauding investors by materially overstating operating revenue, earnings, and growth trends in earnings releases and SEC filings from September 2000 through March 2004.

According to the SEC's complaint, Cardinal Health:

- Fraudulently manipulated certain balance sheet reserve accounts in an attempt to manage the Company's reported earnings.
- Made other adjustments to certain reserve accounts that were not in accordance with GAAP.

Specifically, Cardinal Health made at least 73 different period-end adjustments in 60 different reserve accounts, resulting in an overstatement of the Company's net earnings of approximately $65 million.

Cardinal Health's abuses appear to have been systematically executed by management.

- Reserve balances or excesses were reported to Cardinal's corporate management on a quarterly basis.
- Corporate management then analyzed the reserve balances and sometimes directed business unit employees to use release reserves in order to help Cardinal Health meet its earnings goals.
- In virtually every quarter, Cardinal Health analyzed various reserve adjustments to show the effect those adjustments would have on the Company's earnings per share (EPS).

In many instances, Cardinal Health internally identified a reserve (or portion thereof) as an "available item not used," indicating that the reserve should have been reversed at that time but was maintained and available to help the Company meet its earnings goals in a future quarter.

Also, in at least one instance, Cardinal Health improperly created and built up a general contingency reserve eventually totaling $2 million, in the absence of a specific liability that was reasonably estimable. Cardinal later adjusted this reserve downward to boost reported earnings. In a December 2002 email exchange, two members of the Company's corporate management discussed reversing the $2 million general reserve "to help make the quarter" and noted that "we built it for a rainy day… and it looks like it is pouring!"

Cardinal Health was also accused by the SEC of other wrongdoing with regard to the company's financial reporting.

The SEC asserted that Cardinal Health deliberately presented a false picture of its operating results to the financial community and the investing public in order to match the company's publicly disseminated earnings guidance and analysts' expectations rather than to reflect its true economic performance. Without admitting or denying the allegations, Cardinal Health agreed to pay $35 million to settle with the SEC.

SELECTED FINANCIAL STATEMENT FRAUD CASE STUDIES

Introduction

The following cases represent some of the most blatant examples of financial statement fraud. While we will look at a number of other cases throughout this seminar, the fraudulent activities completed by these companies will be instructive throughout the day today.

Three cases are described below to illustrate the use of fraudulent accounting practices and to further illustrate the characteristics that existed that allowed these fraudulent practices to continue without being discovered in the normal course of business.

HealthSouth

In 2003, HealthSouth had $4.5 billion of revenue with 60,000 employees in 2,000 facilities throughout the country.

In 2003, the SEC accused HealthSouth of overstating earnings by at least $1.4 billion in order to meet or exceed earnings expectations established by Wall Street analysts. The SEC alleged that between 1999 and the second quarter of 2002 HealthSouth intentionally overstated its earnings identified as "Income Before Income Taxes and Minority Interests" by at least $1.4 billion in reports filed with the SEC. The following table illustrates the details of the alleged fraud.

Income (Loss) Before Income Taxes and Minority Interests (in $ millions)	**1999 Form 10-K**	**2000 Form 10-K**	**2001 Form 10-K**	**For 6 Months Ended 6/30/02**
Actual	$(191)	$194	$ 9	$157
Reported	230	559	434	340
Misstated Amount	$421	$365	$425	$183
Misstated Percentage	220%	188%	4,722%	119%

The accounting fraud itself consisted of reducing contra revenue accounts and/or decreasing expenses while correspondingly increasing property, plant, and equipment accounts. The contra revenue account estimated the differences between the gross amounts billed for patient services and the amounts that insurance companies and Medicare would pay for the specific treatment. HealthSouth management knew that its outside auditors (Ernst & Young) would only question additions to fixed assets, if the additions exceeded a certain dollar threshold. As a result, HealthSouth was careful not to exceed this threshold. HealthSouth also created false documents to support its fictitious accounting journal entries.

In summary, HealthSouth participated in a multi-element fraud to accomplish the following:

- *Overstatement of earnings*
- *Meet earnings expectations*
- *Use of reducing contra revenue accounts and decreasing expenses*
- *Increasing property, plant, and equipment while not acquiring the assets*
- *Materiality abuse*

How Discovered

Principal fraudster was CEO Richard Scrushy. Scrushy had employees make up numbers and transactions. In 2003, Scrushy sold upwards of $75 million of HealthSouth stock to avoid an expected stock price collapse when they had to recognize significant losses due to prior fraudulent overstatements. The stock sale and the significant losses caused an SEC investigation.

Tyco

From 1996 through 2002, Tyco overstated and smoothed net income by over $1 billion. During these years, Tyco acquired hundreds of companies and utilized improper accounting practices by undervaluing acquired assets, overvaluing acquired liabilities, and establishing unnecessary reserves for future contingencies. In addition, Tyco overstated revenue from "connection fees" that lacked economic substance and did not meet the criteria for revenue recognition.

Understating acquired assets benefited Tyco's earnings by decreasing depreciation expense in future periods for plant and equipment and increasing earnings. Overstating acquired liabilities allowed Tyco to maintain inflated reserves that Tyco reduced in future periods to inflate earnings.

A subsidiary of Tyco, ADT Security Services Inc., regularly purchased contracts from unrelated security alarm dealers to provide residential and commercial security systems. ADT implemented a $200 "connection fee" to be paid by the dealers to ADT for each contract purchased. This connection fee was recognized in full as revenue on the income statement. At the same time, ADT increased the price it paid to the dealers for the contracts by the same $200. This $200 was amortized over 10 years. Using this technique, Tyco inflated its revenue and net income by over $550 million. The "connection fee" was a sham transaction with $200 coming into Tyco and $200 going out of Tyco. The transaction had no economic substance.

On April 17, 2006, the SEC finalized a settlement over these actions that included financial statement restatements and civil penalties against Tyco.

Tyco was a heavily decentralized organization involved in an aggressive acquisition growth program (acquired over 100 companies in six years), with aggressive earnings targets, and aggressive incentive compensation programs. They also had a weak board of directors that permitted Dennis Kozlowski, then Chairman of the Board and CEO, to run the company without any effective oversight.

Tyco is a classic example of an organization that exhibited many of the characteristics of companies that participate in fraudulent financial reporting.

Note: There were other irregularities at Tyco related to compensation, reimbursed personal expenses, use of top-side journal entries adjusting balances after closing, and unpaid loans which were not accounting related and not part of the Tyco settlement.

Tyco supported an aggressive acquisition strategy designed to misrepresent the accounting outcomes of these acquisitions:

Overstated and smoothed net income

Undervalued acquired assets

Overvalued acquired liabilities

Established unnecessary reserves for future contingencies

Overstated connection fees

The company characteristics that led to and supported this financial statement fraudulent activity include:

- *Decentralized organization*
- *Aggressive acquisition growth program*
- *Aggressive earnings targets*
- *Incentive compensation programs linked to earnings results*
- *Weak board of directors*
- *Limited corporate oversight of operations*

How Discovered

CEO and CFO stole over $150 million and inflated or smoothed income by $1 billion. Based on the Tyco board forgiving large loans made to the CEO, the SEC investigated the appropriateness of this activity and discovered fraudulent accounting transactions during this period.

Enron

Enron was an energy and services corporation operating previously as Houston Natural Gas. Enron was formed in 1985 by Ken Lay. Later Jeff Skilling was hired to partner with Ken Lay in the largest accounting scandal in corporate history. (Reported revenue of $101 billion in the year 2000 was overstated by between $60 and $90 billion.) This scandal was a multi-element fraud consisting of misleading accounting outcomes, poor financial reporting practices, and the use of off-balance sheet entities to borrow money and then convert these borrowings to sales while at the same time not consolidating the off-balance sheet entities.

A major driver of this fraud was the use of management incentive compensation plans without appropriate controls or oversight that lead to a corporate culture that accepted any practice consisting of any activity as long as it improved earnings. Enron is a classic example of controls and governance failing due to its culture of "anything goes" as long as it increases earnings.

Often, when one thinks of the Enron fraud, one applies the concept of having three legs of a stool. As long as the three legs are functional, the stool stands erect. At Enron, the three legs represent the Board or Audit Committee, internal auditors, and external auditors. The Board and Audit Committee consisted of friends and business acquaintances of Ken Lay who failed in their oversight responsibility; internal audit reported to Andy Fastow – the CFO who was instrumental in hiding the fraudulent accounting transactions; and the external auditor, Arthur Anderson, received fees totaling $50 million a year from Enron and was willing to look the other way when inappropriate or fraudulent accounting and reporting practices were identified. In other words, all three legs of the stool failed, permitting this fraud to continue for over seven years.

How Discovered

A Company whistleblower went public to the SEC concerning the company.

Observation

While these three cases all took place some time ago, they continue to be the poster child for examples of fraudulent behavior. We will look at other fraud cases throughout this program and it will be interesting to see the frequency that certain fraudulent activities continue to take place.

RESPONSIBILITY FOR FRAUD PREVENTION AND DETECTION

The Center for Audit Quality of the AICPA indicates that the responsibility for mitigating the risk of financial reporting fraud sits with four primary parties as described as the financial reporting supply chain:

1. **Board of directors and audit committee** – responsible for corporate governance and oversight. In this role, they should establish a tone at the top reducing fraud risks and driving antifraud behavior. The board and audit committee is responsible for ensuring that management effectively assumes and carries out its fraud risk management program and sets the appropriate culture for management and employee behavior.

2. **Internal audit** in its capacity of being independent of management – it should create an objective assurance that fraud risks are mitigated. Internal audit should also be the first line of defense if fraudulent activity is suspected and their access to the board of directors and the audit committee should assure effective communications within the organization. Internal audit should never report to management but always to the board or audit committee.

3. **External audit** in its role of providing external independent assurance – that fraud risks are mitigated and internal controls are effective. External audit, while not providing 100 percent assurance that fraud has not occurred, does provide a high level of assurance that the financial statements are fairly presented and that obvious material errors do not exist.

4. **Management**, having the primary responsibility for the financial reporting process, reinforces the tone at the top and is responsible for implementing an effective fraud risk management program. For example, management is responsible for the day-to-day operations of the business and has the authority over systems, controls, data, and employees. Management must create a culture where fraud is not tolerated by identifying fraud risks and taking action when fraud risks increase or fraud is suspected.

If management's responsibility is to prevent and detect fraudulent activity, then management must establish the appropriate tone at the top as to what expected behavior is among management and employees. Tone at the top refers to the environment that is developed at the organization by the organization's leadership. This requires leading by example. This tone at the top creates a culture that is unique to the organization and drives management and employee behavior. The tone at the top would include the incentives and disincentives that are in place to drive the appropriate management and employee behavior to ensure that management and employees behave in a manner consistent with the organization's goals and objectives.

EXAMPLE

Colonial Bank Fraud

Colonial Bank was a bank holding company located in Alabama with $26 billion in assets. For over 15 years, a fraud was occurring as Colonial's largest customer, a mortgage originator, colluded with a number of Colonial employees. As part of this fraud, the mortgage originator continued to overdraw his bank account to a cumulative amount of $120 million, but these overdrafts were never reported internally by bank employees, causing an overstatement of the bank's cash balance.

The mortgage originator also sold Colonial Bank worthless mortgages that had already been sold once. In effect, cash was paid to the mortgage originator for mortgage assets that had no value. Over time, these mortgage assets grew on the balance sheet. The total amount of both types of fraudulent activities grew to about $1.5 billion by 2017.

As indicated in the federal court decisions related to this case in 2017 and 2018, a number of Colonial executives colluded with the mortgage originator to hide the fraudulent transactions. They falsified data, forged documents, concealed the impaired mortgages, hid any fraud related communications, and lied to the auditor, PricewaterhouseCoopers (PwC).

This fraud is a classic example of the corporate culture (tone at the top) at Colonial Bank that permitted its employees and its largest customer to commit a massive fraud: they decided that these types of fraudulent activities were acceptable as long as each individual and the bank benefitted.

Each of these parties must apply an appropriate amount of **skepticism** to effectively perform their responsibilities. *The Fraud-Resistant Organization* (published by the Anti-Fraud Collaboration) states that, "Skepticism throughout the financial reporting supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted."

As will be discussed in this program, the Committee of Sponsoring Organizations (COSO) has created in COSO Principle 8 the need for companies to develop internal fraud controls based around the **COSO model**, which includes the following:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication

- Monitoring Activities

This COSO model is the responsibility of management to create and maintain, but it is the board and audit committee's responsibility to provide oversight of management in this area and it is internal and external audits' responsibility to assess whether this COSO model is operating sufficiently to prevent or detect fraudulent activity. Note: COSO is now an important part of the recently-implemented 2017 SOC2 reporting framework which went into effect on December 16, 2018.

FRAUD THEORY

Fraud Theory – what is it? To understand fraud, we must understand the conditions that can lead someone to commit fraud. These conditions can be described as either fraud motivators or as the fraud triangle. We look at both below.

Fraud Motivators

To prevent or detect fraud, companies must be able to identify employee or corporate fraud motivators. This requires training and monitoring of activities. Employee fraud motivators can be characterized as follows:

- *Greed* – Employee never satisfied with compensation or recognition – always wants more
- *Need* – Employee cannot meet personal financial obligations. Sometimes caused by gambling, lifestyle, or an addiction
- *Entitled* – Employee believes he/she has earned a right (promotion, for example) or benefit (bonus, for example) and has been unfairly denied the right or benefit
- *Abused* – Employee believes the company (management or other employees) are unfairly treating the employee

All of these employee fraud motivators are fraud risks that must be identified and monitored by management. Let's look at the following example.

EXAMPLE

Mary was employed in the human resources department of a company. At her annual review, she expected to be given an excellent performance evaluation and, as a result, receive a 10% increase in her base pay. Unfortunately, her manager did not see her performance in the same way and gave her a "needs improvement" review in a number of areas resulting in only a 3% increase in base pay.

Mary was incensed with her performance review and salary increase and felt entitled to the 10% increase. She believed that she was unfairly treated by her manager and vowed to obtain the 10% increase even if she had to steal the difference.

Mary worked in human resources and had access to all employee payroll data, including her own. Mary went into the payroll system and gave herself a base salary increase of 7%. When added to the 3% salary increase provided by her manager, Mary had her 10% increase.

While clearly internal controls were not adequate in this company, the driving conditions for Mary's behavior were the employee fraud motivators of entitled and feeling abused.

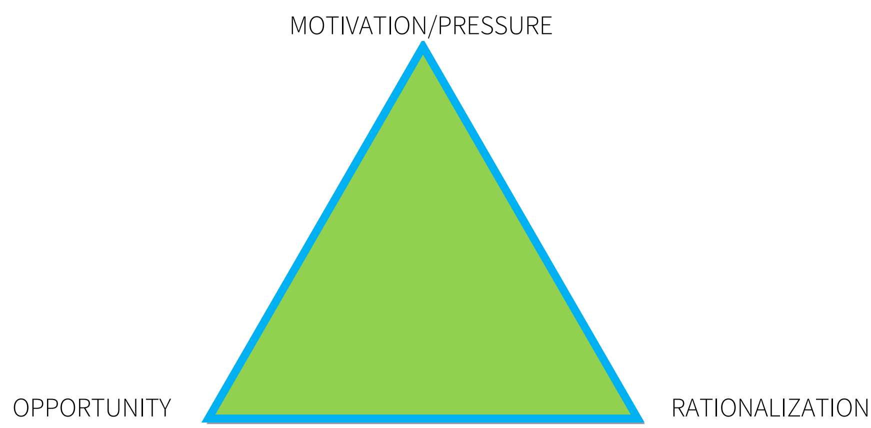
Corporate fraud motivators may be influenced by employee fraud motivators, but they take are normally expressed with corporate or company characteristics:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Comply with debt covenants
- Conceal the company's deteriorating financial condition
- Maintain or increase the company's stock price
- Improve the company's financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

Corporate fraud motivators often are more associated with preventing embarrassment, losing a job, helping to maintain a reputation, or achieving incentive compensation.

Fraud Triangle

The Association of Certified Fraud Examiners (ASFE) has developed the Fraud Triangle to explain the factors that cause someone to commit fraud. The Fraud Triangle consists of the following three components:



- **Motivation/Pressure** – Motivation/pressure can be performance-based, due to personal financial difficulty, or as a result of personality conflicts with someone at the company. There is normally a desire for personal or professional gain or causing injury and/or embarrassment for someone else.

- **Opportunity –** Access to assets and/or financial information, made possible by weak internal controls or a perpetrator's senior position within the company.

- **Attitude/Rationalization** – The actions taken are consistent with some greater good – either the company's good or the individual's good. Individuals rationalize, for example, that improper revenue recognition is appropriate because of the benefits that accrue to them, even if others are damaged.

The following provides a few examples of each of the components of the Fraud Triangle. These components, as well as their related fraud risk factors when considering Fraud Risk Assessments, will be discussed in more detail later in this course.

Motivation/Pressure

- Meeting corporate performance goals
- Pressure of the job or position
- Financial obligations – misuse of credit cards

Opportunity

- Ineffective internal controls
- Poor segregation of duties
- Inadequate supervision

Attitudes/Rationalization

- Perceived poor treatment by someone
- It is in the best interest of the shareholders
- Can always correct it at a later time
- Will only do it once

SOFT AND HARD INDICATORS OF FRAUD

Indicators of fraud can be described as "soft" or "hard." Soft indicators are indirect activities or circumstances that suggest something else may be taking place that is being concealed and that an investigation should take place. Hard indicators are specific or direct activities or circumstances that suggest fraudulent activity has taken place. Companies need to be alert for both soft and hard indicators of fraud in their fraud risk management programs.

Below are lists of soft and hard indicators of fraud.

Soft Indicators of Fraud

- Risk taker
- Likes to “beat the system”
- Refusal to take time off
- Coming in early/staying late
- Drug/alcohol abuse
- Lavish lifestyle
- Personal financial problems
- Divorce/family problems
- Self-control issues

Hard Indicators of Fraud

- Discrepancies in accounting records
- Conflicting or missing documentation
- Frequent changes in accounting estimates
- Frequent resignations of accounting or finance personnel
- Transactions not completed in a complete or timely manner
- Unsupported or unauthorized balances or transactions
- Last minute adjustments that significantly affect accounting results
- Evidence of management override
- Unexplained differences between subledgers and control accounts
- Missing inventory or other physical assets
- Financial reporting results significantly different from competitors in the same industry

WHO COMMITS FRAUD?

Again referencing *The Fraud-Resistant Organization*, we have the following information:

- Age of fraudster – between 36 and 55
- Overwhelmingly male
- Generally a member of management
- The fraudster works in finance or operations/sales and is frequently the CEO
- Time with the organization – 33% over 10 years; 56% between 3 and 10 years
- Fraud was committed in collusion with others 69% of the time
- Internal controls were overridden in 74% of the cases

A major factor that often directly causes organizations to become victims of fraud is the **trust factor**. The more trust a company has in an employee, the more risk exists that fraud will take place. Cases have demonstrated that many employees exploit this trust factor to commit fraud against their employers. Trusted employees with long-time work experience are at most risk of committing fraud. Combined with pressure, opportunity, and rationalization, these trusted employees represent high fraud risk. Suggested solutions to minimize this fraud risk include rotation of job duties, mandatory vacation, close supervision, and more project assignments instead of recurring responsibilities.

Unit 2

Fraud Risk Assessments

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- Describe the five principles included in Managing the Business Risk of Fraud: A Practical Guide report
- Identify fraud risk factors associated with financial statement fraud

INTRODUCTION

When looking at the topic of Fraud Risk Assessments, the four best places to gather appropriate related information is:

1. PCAOB AS 2110: Identifying and Assessing the Risks of Material Misstatement
2. PCAOB AS 2401: Consideration of Fraud in a Financial Statement Audit, and
3. ASB AU-C Section 240: Consideration of Fraud in a Financial Statement Audit
4. Managing the Business Risk of Fraud: A Practical Guide – Sponsored by The Institute of Internal Auditors, The American Institute of Certified Public Accountants, and The Association of Certified Fraud Examiners

All base their discussion on fraud risk assessments and the identification of fraud risk factors on the Fraud Triangle. The emphasis is on motivation or pressure to commit fraud, the opportunity to commit fraud, and how committing the fraud is rationalized or justified by the fraudster.

According to the Association of Certified Fraud Examiners, **fraud risk assessment** is a process of proactively identifying and addressing an organization's vulnerabilities (fraud risks) to internal and external fraud – the objective of which is to help an organization identify what makes it most vulnerable to fraud. Factors that influence fraud risk include:

- The nature of the business the organization is in
- The environment in which the organization operates

- The effectiveness of the organization's internal controls
- The ethics and values of the organization and its employees – Corporate culture

Fraud risk assessments can be the results of management and employee interviews, use of focus groups, surveys, customer and vendor feedback, as well as past experience. Examples of **fraud risk factors** can include:

- Management override of internal controls
- Changing assumptions or judgments supporting significant estimates
- Backdating purchase or sales agreements
- Fictitious or unapproved journal entries
- Partial shipments of inventory to customers
- Unnecessarily complex transactions
- Related party transactions
- Unusual non-recurring transactions
- Poor tone at the top (management)
- Delayed closing of the books

AS 2401 makes it clear that it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud. Further, management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions consistent with management's assertions contained in the financial statements. When management and those in charge of governance fulfill these responsibilities, the opportunities to commit fraud can be reduced significantly.

When companies create their accounting policies and internal controls designed to prevent and/or detect financial statement fraud, they must first perform **fraud risk assessments** to identify the likelihood and magnitude of fraud risk. Performing fraud assessments is part a fraud risk assessment model as described in the *Managing the Business Risk of Fraud: A Practical Guide* report.

This model consists of the following five principles:

1. As part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

2. **Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate**.

3. Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

4. Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

5. A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

The fraud risk assessment in Principle 2 above consists of three basic elements:

1. Fraud risk identification (fraud risk factors)

2. Evaluate the likelihood and magnitude of the fraud risk

3. Develop an appropriate risk response

FRAUD RISK FACTORS

Looking at financial statement fraud, the Fraud Triangle presents three conditions that are generally present when material misstatements due to fraud take place:

1. Motivation/pressures

2. Opportunities

3. Attitudes/rationalization

Of course, more obvious conditions sometimes exist such as discrepancies in accounting records and conflicting or missing evidence. These obvious conditions are significant red flags suggesting something is wrong in the financial reporting process and the possibility of intentional fraudulent misstatement must be considered.

The three conditions identified in the Fraud Triangle can be broken down into fraud risk factors that are generally present when financial statement fraud takes place. These fraud risk factors can be found in AS 2401 and AU-C 240.

Motivation/Pressures

- Is the financial stability or profitability threatened by economic, industry, or organization operating conditions, such as indicated by the following fraud risk factors?

  – High degree of competition or market saturation, accompanied by declining margins

  – High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates

  – Significant declines in customer demand and increasing business failures in either the industry or overall economy

- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent

- Recurring negative operating cash flows or an inability to generate cash flows from operations while reporting earnings and earnings growth (quality of earnings)

- Rapid growth or unusual profitability especially compared to that of other companies in the industry

- New accounting, statutory, or regulatory requirements that may negatively impact earnings or cash flows

■ Does excessive pressure exist for management to meet the requirements or expectations of third parties due to the existence of the following fraud risk factors?

- Profitability or trend level expectations of investment analysts, institutional investors, creditors, or other external parties, including expectations created by management in, for example, overly optimistic press releases or annual report messages

- Need to obtain additional debt or equity financing to stay competitive-including financing or major projects or capital expenditures

- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements

- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

- A need to achieve financial targets required in bond covenants

- Pressure for management to meet the expectations of legislative or oversight bodies or to achieve political outcomes, or both

■ Is management or the board of directors' personal financial situation threatened by the organization's financial performance arising from the following fraud risk factors?

- Significant financial interests in the organization

- Significant portions of their compensation is contingent on achieving aggressive targets for stock price, operating results, financial position, or cash flow

- Personal guarantees of debts of the organization

■ Is there is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including fraud risk factors associated with sales or profitability incentive goals, budgets, or publicized forecasts or projections?

■ Are earnings expected to be "managed" at the subsidiary or division level, creating pressures on lower-level managers to meet higher level management expectations?

- Is there a perception of adverse consequences on lower-level managers if subsidiaries or divisions fail to exceed or fall short of budgeted, projected, or forecasted results?

EXAMPLE

One of the more infamous accounting scandals in U.S. history is the case of WorldCom. At the time, WorldCom was a telecommunications giant with a market cap of $175 billion. Bernie Ebbers, CEO, and Scott Sullivan, CFO, helped to grow WorldCom by buying other telecom companies to grow the business and gain market share. Unfortunately, for Ebbers and Sullivan, companies around the world cut back on spending for telecommunications systems as the Internet and email started to become a reality, and cable companies like Comcast started to take customers and market share from WorldCom.

To prevent the reporting of declining income and market share, as well as to protect the price of their shares, Ebbers and Sullivan created a scheme whereby they inflated net income by recording expenses as assets and made false journal entries to inflate revenue. It is estimated that they overstated assets and income by over $11 billion. Internal audit discovered the fraud when they performed a fixed asset inventory and could not find the assets. A further review indicated that the fixed assets recorded were never paid for nor was debt incurred for their purchase.

Following the discovery of WorldCom's financial statement fraud, Congress passed the Sarbanes-Oxley Act (SOX).

Pressure/Motivation – Maintain market share and protect the price of the stock

Opportunity – CEO/CFO involved

Attitude/Rationalization – It is in the best interest of the shareholders

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Opportunities

- Does the nature of the industry or the organization's operations provide opportunities to engage in fraudulent financial reporting, such as indicated by the following fraud risk factors?
  - Related party transactions that may also be unusual transactions
  - Significant transactions with related parties whose financial statements are not audited or audited by a firm different from the entities auditors
  - A strong financial presence or ability to dominate a certain industry sector that allows the organization to dictate terms or conditions to suppliers or customers that may result in inappropriate or non–arm's length transactions
  - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to confirm
  - Significant, unusual, or highly complex transactions, especially those close to year-end that may cause difficult substance over form questions
  - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exists (acceptance of bribery, for example)

  - Use of business intermediaries when there appears to be no clear business justification

  - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions when there appears to be no clear business justification

  - Contractual arrangements appearing to lack a business purpose

- Are significant estimates used in the annual or quarterly financial reporting process unrealistic or inconsistent with actual historical results or with the performance of other entities in the same industry?

- Is there is ineffective monitoring of management as indicated by the following fraud risk factors?

  - Domination of management by a single person or small group without compensating controls (Tyco, for example)

  - Ineffective board of directors or audit committee oversight over the financial reporting process and internal control (Enron and Tyco, for example)

  - Dominant related party exists that can influence organization operations and financial results

- Is there is a complex or unstable organizational structure, as evidenced by the following fraud risk factors?

  - Difficulty in determining the organization or individuals that have controlling interest in the organization

  - Overly complex organizational structure involving unusual legal entities or managerial lines of authority

  - High turnover of senior management, counsel, or board members

- Are internal control components deficient as indicated by the following fraud risk factors?

  - Inadequate monitoring of controls, including automated controls and controls over interim financial reporting

  - High turnover rates or employment of staff in accounting, IT, or the internal audit function

  - Ineffective accounting and information systems, including situations involving internal control reportable conditions

  - Weak controls over budget preparation and development and compliance with laws or regulations

- Are there indications that the qualifications and capabilities of the finance or accounting organizations and key personnel need significant improvement?

EXAMPLE

An example of fraud embezzlement through having the opportunity using cost of goods sold as the vehicle to hide theft of company cash is the Koss Corporation. Koss Corporation, the designer and marketer of stereo phone earphones, alleges that its CFO, Sue Sachdeva, embezzled over $31 million of the company's cash in a six-year period. Koss reported the following amounts stolen:

- 2005 – $2,200,000
- 2006 – $2,200,000
- 2007 – $3,200,000
- 2008 – $5,000,000
- 2009 – $8,500,000
- 2010 – $10,000,000

According to the criminal complaint filed on December 21, 2009, Sue Sachdeva, CFO, used company funds to support an elaborate personal lifestyle. She charged personal items on her American Express card and then made wire transfers of company cash to pay the American Express shopping bills.

It is alleged that Sue Sachdeva charged the payments to American Express to cost of goods sold. What is surprising concerning this alleged embezzlement is the size of the fraud vs. the size of the company. Koss Corporation's annual sales are approximately $40,000,000 with net income in the range of $7 to $8 million in recent years. Over the six-year period, the fraud averaged $430,000 a month!

Obviously, the message at Koss Corporation is the lack of effective oversight by the board and the lack of effective internal controls (checks and balances) within the accounting operation. Sue Sachdeva was a veteran of Koss Corporation, being employed there for over 17 years and highly respected and trusted. The board and other management personnel at Koss Corporation apparently did not pay much attention to the finances of the company and relied solely on Sue Sachdeva for any financial information.

Sue Sachdeva was sentenced to an 11-year federal prison sentence in 2011, and Grant Thornton, in 2013, paid $8.5 million to Koss Corporation to settle negligent claims made against Grant Thornton by Koss Corporation.

Pressure/Motivation – Greed

Opportunity – CFO involved, poor internal controls

Attitude/Rationalization – Confident she would not get caught because she was in charge of finance

Attitudes/Rationalizations

- Attitudes/rationalizations used by board members, management, or employees when committing fraudulent financial reporting many not be obvious to those performing oversight of the financial reporting process including external and internal auditors. The following fraud risk factors should be carefully monitored by those responsible for oversight of the financial reporting process:

- Is there ineffective communication, implementation, support, or enforcement of the organization's values or ethical standards by management or the communications of inappropriate values or ethical standards (Enron, for example)?

- Is there any evidence of nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates?

- Is there a known history of violations of securities laws or other laws and regulations, or claims against the organization, its senior management, or board members alleging fraud or violations of laws and regulations?

- Is there excessive interest by management in maintaining or increasing the organization's stock price or earnings trends?

- Is there a practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts?

- Has management failed to correct known reportable conditions on a timely basis?

- Has management demonstrated an interest in employing inappropriate means to minimize reported earnings for tax-motivated reasons?

- Have there been recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality?

- Is there a strained relationship between management and their current or predecessor auditors?

- Has management failed to identify business risks on a timely basis or failed to adequately monitor identified risks?

- Has management been unwilling to address, on a timely basis, issues that could result in significant financial statement adjustments or negative disclosures?

- Does management make no distinction between personal and business transactions?

■ When considering fraud risk factors in the area of attitude/rationalization, those with oversight responsibility must also consider the fraud risk factors related to the potential individuals who might commit financial statement fraud. The following are fraud risk factors that often are associated with the individuals who have committed financial statement fraudulent activity:

- They believe that if "I benefit, others also benefit."

- They often believe that they are entitled to certain benefits (bonus, stock options, salary increase, etc.) that they have not received.

- They perceive they are receiving poor treatment by management or other employees.

- They believe that they can always correct it at a later time without being caught.

- – Will only do it once until they realize that they got away with it once and can do it again.
- – They believe nobody is going to get hurt.
- – They are confident they will not get caught because they are smarter than everyone else.

EXAMPLE

In March 2002, the stock of Adelphia Communications, the sixth largest U.S. cable provider at that time, lost 2/3 of its value when questionable accounting practices for related party transactions were disclosed. CEO John Rigas and his three sons secretly secured loans for $2.3 billion from Adelphia family partnerships, which were all guaranteed by Adelphia Communications. Although the family's spending to support an extravagant lifestyle was widely publicized, the proceeds were used primarily to regain control of the company. The extent of the fraudulent activity was significant. For example:

- The family excluded billions of dollars in liabilities from Adelphia's consolidated balance sheet by hiding them in off-balance sheet affiliates.
- The family created numerous related party transactions resulting in an understatement of liabilities.
- The family engaged in rampant self-dealing at Adelphia's expense:
  - – Adelphia misrepresented significant transactions when the family used Adelphia resources with no reimbursement or compensation to Adelphia.
  - – Adelphia paid at least $241 million in personal margin loans for the family.

Pressure/Motivation – Greed

Opportunity – CEO involved, management override of controls

Attitude/Rationalization – CEO made no distinction between personal and business transactions

COMPREHENSIVE EXAMPLE

The Rite Aid accounting scandal represents a multi-element fraud in that numerous fraudulent techniques were used to overstate net income for a three-year period by $1.6 billion. The motivation for this financial statement fraud was to increase the price of the stock and to enable Rite Aid to borrow more money to continue an acquisition spry buying smaller drug store chains to improve market share. CEO, Martin Grass, and CFO, Frank Bergonzi, were primarily responsible for this accounting fraud.

The SEC charged that Grass sought to enrich himself at the expense of Rite Aid's shareholders. The SEC also accused Grass of fabricating Finance Committee minutes for a meeting that never occurred, in connection with a corporate loan transaction. The techniques used to overstate net income included:

- *Upcharges* – Rite Aid systematically inflated the deductions it took against amounts owned to vendors for damaged and outdated products. For vendors who did not require the unusable products returned to them, Rite Aid applied an arbitrary multiplier to the proper deduction amount, which resulted in overcharging its vendors by $8 million and $28 million for two years.
- *Stock Appreciation Rights (SAR)* – Rite Aid failed to report an accrued expense for SARs it had granted to employees. Rite Aid should have accrued an expense of $22 million and $33 million for two years.
- *Gross Profit Entries* – Bergonzi directed Rite Aid's accounting staff to make top-side adjusting entries to reduce quarterly cost of sales and accounts payable to manipulate Rite Aid's reported quarterly earnings. These top-side adjustments totaled in the hundreds of millions of dollars.

- *Vendor Rebates* – Bergonzi made additional journal entries to reduce accounts payable and cost of goods sold by $75 million to reflect vendor rebates Rite Aid was not entitled to. Rite Aid had not earned these vendor rebates and had no legal right to receive them.
- *Dead Deal Expense* – Rite Aid incurred costs for new store sites such as legal fees, title searches, architectural drawings etc., that were capitalized when incurred. Many of these potential new store sites were rejected and under GAAP, and these costs should have been expensed at the time of being rejected. Rite Aid routinely carried these expenses as assets on their balance sheet.
- *Inventory Shrink* – For two years, Rite Aid failed to record inventory shrink representing theft or breakage. For a two-year period, this totaled $14 million.

In addition, Grass did not disclose his personal interest in three properties that Rite Aid leased as store locations. Rite Aid was obligated under GAAP, to disclose these interests as related party transactions. Grass never disclosed an additional series of transactions, in which he funneled $2.6 million from Rite Aid to a partnership controlled by Grass and a relative. The partnership used $1.8 million of these funds to purchase an 83-acre property intended for a new Rite Aid headquarters. Subsequently, Rite Aid paid over $1 million in costs related to the site even though it was owned by the partnership, and not Rite Aid.

Clearly the tone at the top was, at a minimum, unethical and, at a maximum, the tone at the top indicated that fraudulent financial reporting was acceptable to achieve the stock price and earnings trends desired by Grass and Bergonzi.

Clearly this example illustrates the Fraud Triangle in action:

- Motivation/Pressures – Increase the price of the stock/improve financial performance to enable more borrowing
- Opportunities – CEO and CFO directed the fraud
- Attitudes/Rationalizations – Excessive interest in management in increasing the organization's stock price and earnings trends

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IMPORTANCE OF INQUIRIES

AS 2110: *Identifying and Assessing Risk of Material Misstatement*, suggests that inquiries of the audit committee, management, and others within the organization concerning the risks of fraudulent financial reporting can help identify fraud risk factors and then address these fraud risk factors with the intent of mitigating their risk. These fraud risk inquiries can consist of the following:

Inquiries of management regarding:

- Whether management has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;
- Management's process for identifying and responding to fraud risks in the company, including any specific fraud risks the company has identified or account balances or disclosures for which a fraud risk is likely to exist, and the nature, extent, and frequency of management's fraud risk assessment process;
- Controls that the company has established to address fraud risks the company has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls;

- For a company with multiple locations, (a) the nature and extent of monitoring of operating locations or business segments and (b) whether there are particular operating locations or business segments for which a fraud risk might be more likely to exist;

- Whether and how management communicates to employees its views on business practices and ethical behavior;

- Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints;

- Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud; and

- Whether the company has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved related parties.

Inquiries of the audit committee, or equivalent, or its chair regarding:

- The audit committee's views about fraud risks in the company;

- Whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

- Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints;

- How the audit committee exercises oversight of the company's assessment of fraud risks and the establishment of controls to address fraud risks; and

- Whether the company has entered into any significant unusual transactions.

If the company has an internal audit function, inquiries of appropriate internal audit personnel regarding:

- The internal auditors' views about fraud risks in the company;

- Whether the internal auditors have knowledge of fraud, alleged fraud, or suspected fraud affecting the company;

- Whether internal auditors have performed procedures to identify or detect fraud during the year, and whether management has satisfactorily responded to the findings resulting from those procedures;

- Whether internal auditors are aware of instances of management override of controls and the nature and circumstances of such overrides; and

- Whether the company has entered into any significant unusual transactions.

Examples of other individuals within the company to whom inquiries might be directed include:

- Employees with varying levels of authority within the company including, e.g., company personnel with whom the auditor comes into contact during the course of the audit (a) in obtaining an understanding of internal control, (b) in observing inventory or performing cutoff procedures, or (c) in obtaining explanations for significant differences identified when performing analytical procedures;

- Operating personnel not directly involved in the financial reporting process;

- Employees involved in initiating, recording, or processing complex or unusual transactions, e.g., a sales transaction with multiple elements, a significant unusual transaction, or a significant related party transaction;

- In-house legal counsel.

TRANSITION

Units 1 and 2 were designed to primarily address fraud theory and fraud risk assessments including the Fraud Triangle. In both units we presented a number of fraudulent financial statement examples. In unit 3, we will look at specific account or disclosure schemes that entities have used to commit financial statement fraud. These schemes include:

- Improper revenue recognition

- Improper asset recognition or valuation

- Concealed liabilities and expenses

- Improper disclosures

Unit 3

Frequent Financial Statement Fraud Schemes

LEARNING OBJECTIVES

After completing this section, participants will be able to:

- Identify examples of schemes and methods used by fraudsters to commit financial statement fraud
- Identify red flags of financial statement fraud

INTRODUCTION

The purpose of this section is to describe schemes or methods used by fraudsters to commit financial statement fraud and identify red flags that can direct management and others to investigate suspicious or unusual activity that could lead to heightened fraud risk. Schemes described in this section include the following:

- Improper revenue recognition
- Improper asset recognition or valuation
- Concealed liabilities and expenses
- Improper financial statement disclosures

Each of the four fraud risk schemes identified above will be described in the remainder of this section with specific red flags associated with each fraudulent method. What all of these fraudulent methods have in common though are the techniques management uses to commit financial statement fraud. The following are **four common techniques found in the majority of financial statement frauds**:

1. **Misuse of journal entries** – The easiest way to manipulate financial information is to simply change an amount recorded or change the account(s) the transaction impacts. Many frauds

(Tyco, for example) used top-side journal entries after closing to manipulate the financial reporting results.

Certain red flags that are indicative of fraudulent journal entries include:

- Entries are made to accounts with little activity by individuals who don't have the responsibility for journal entries
- Nonrecurring top-side journal entries are made at the end of an accounting period
- Adjustments are made to accounts with significant estimates
- Entries represent the overriding of internal controls
- The nature of entries made are examples of fraud risk as identified by the reporting organization

2. **Management override of controls** – In the COSO report, *Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies*, the CEO was involved in 72% of financial statement fraud and the CFO was involved in 65% of the cases. The method primarily used by these CEOs and CFOs was to override the internal controls designed to prevent such fraudulent activity from taking place. Senior management, in these cases, is often able to commit these frauds due to their positions in the company and the trust they have developed based on their positions.

   AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, provides examples of techniques used to commit fraud by management overriding controls. These examples are:

   - Recording fictitious journal entries, particularly close to the end of the accounting period, to manipulate operating results or achieve other objectives
   - Inappropriately adjusting assumptions and changing judgments used to estimate account balances
   - Omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
   - Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements
   - Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the organization
   - Altering records and terms related to significant and unusual transactions

3. **Intentional misstatement of accounting estimates** – Significant estimates such as a contingent liability, impaired asset valuation, accruals, restructuring reserves, or credit losses are often developed outside of a company's internal control system and their results can be biased based on whether management is focused on overstatement or understatement of earnings.

4. **Existence of unusual transactions** – Transactions outside of the normal recurring operating transactions that regularly take place or unusual transactions are activities fraudsters will utilize to work around the company's internal controls or other oversight activities. Unusual transactions such as large sales towards the end of the year to a new customer, significant reduction in compensated absences without a corresponding reduction in payroll, significant increase in revenue and earnings without a similar increase in operating cash flows, and liabilities transferred to unconsolidated off-balance entities are examples of the use of unusual transactions to commit fraudulent financial reporting.

Financial statement red flags not specifically associated with the four schemes above include:

- Ineffective governance and oversight by those in charge of governance (board, audit committee, executive management)
- Inappropriate tone at the top
- Fraud risk is not taken seriously by management
- The existence of unusual or unexpected analytic relationships between and among account balances (days sales in receivables and inventory increasing while sales is decreasing)
- Gross profit inconsistent with companies in the same industry sector
- Growing property, plant, and equipment while expenses are decreasing
- Inconsistent results and relationships compared to industry competitors
- Significant increase in revenue and earnings towards the end of the year when the business is not seasonal
- Extensive relationships of unconsolidated off-balance sheet entities
- The existence of poor internal controls – SOX Section 404 noncompliance
- Frequent related party transactions
- Loans to management or to related parties are written off
- Incentive compensation plans for management based on achieving performance targets
- High turnover at the management level
- Executives with past criminal records
- Current company and/or accounting investigations taking place by regulators
- Significant increase in current debt with restrictive compliance requirements
- Complex disclosures lacking effective communications

- Poor quality of earnings
- Lack of vendor oversight

IMPROPER REVENUE RECOGNITION

Due to market pressures, management incentives, potential debt covenant violations, reduced sales, or any number of other factors that can negatively impact a company, improper revenue recognition has become an increasing problem for the accounting profession. Too often, managers believe they must achieve certain revenue and/or profit targets even if it involves improper revenue recognition techniques to achieve those targets.

In 2010, COSO released *Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies*. Among other objectives, this report attempted to identify management characteristics that existed in these companies where financial statement fraud took place.

The following summarizes selected key findings of the report:

- The companies in the study had median sales of approximately $72 million and median company income approximating $875,000.
- In 72% of the cases, the CEO was involved in the frauds and the CFO was involved in 65% of the cases.
- Most frauds were not isolated in a single period but impacted at least two consecutive periods.
- Majority of the fraudulent activity took place close to or as of the end of the fiscal year.
- **60% of the frauds involved overstating revenues by recording revenues prematurely or fictitiously**. Examples of improper revenue recognition practices included:
  - **Sham sales** by falsifying inventory records, shipping documents, and invoices. Shipping goods to another company location was a frequently used technique to overstate revenue.
  - **Premature revenues before all the terms of the sale were completed**. This consisted of recording sales after the goods or services were ordered but before the goods were shipped or the services performed.
  - **Conditional sales**. Sales recognized had unresolved contingencies or the terms of the sale were amended by side agreements that changed the seller's performance obligations.
  - **Improper cutoff of sales**. Accounting records were held open beyond the Balance Sheet date to record sales of the subsequent period in the current period.
  - **Improper use of the percentage of completion method**. Revenues were overstated by accelerating the estimated percentage of completion for projects in process.

– **Unauthorized shipments**. Revenues were overstated by shipping inventory never ordered or by shipping defective inventory and recording revenues at full, rather that discounted prices.

– **Consignment sales**. Revenues were recorded for consignment shipments or for shipments of inventory for customers to consider on a trial basis.

The motivations often found in these fraudulent cases include the following:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Conceal the organization's deteriorating financial position
- Maintain or increase the stock price
- Improve financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

EXAMPLE

In September 2018, the SEC charged Tangoe, Inc., a telecommunications expense management company located in Connecticut, with accounting fraud. The complaint alleges that Tangoe, improperly recognized approximately $40 million of revenue out of a total of $566 million reported during the three-year period ending in 2015. Tangoe's accounting misrepresentations included the following:

- Counting customers' prepayments for future services as current revenue
- Improperly recording a loan from a business partner as revenue
- Recording revenue in the wrong reporting periods
- Prematurely recording revenue from contingent fee arrangements
- Recording revenue from customers who were unlikely to pay
- Prematurely counting revenue from long-term contracts prior to performance

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Improper revenue recognition practices can normally be broken down into four categories fraudulent revenue practices:

1. **Fictitious revenue**. Examples include:

   – Recording fictitious revenue journal entries

   – Billing companies that do not exist

   – Bill and ship inventory to customers who did not order the product

- Shipments made to company owned warehouses followed with revenue recognition using fictitious billing
- Recording borrowings as revenue
- Establishing inflated restructuring reserves in a prior period and reducing these reserves in the future as need to achieve revenue or earnings targets
- Recognizing vendor rebates as revenue rather than reductions in cost of sales

EXAMPLE

Wirecard Fraud

Wirecard, founded in Germany in 1999, provided electronic payment transaction services, risk management, and financial services to its customers. Its primary revenue source was extracting fees for processing credit card transactions for businesses. According to the *Wall Street Journal*, Wirecard allegedly processed $140 billion of transactions a year on behalf of a quarter million businesses. On June 17, 2020, Wirecard had a stock value of $14 billion. On June 25, Wirecard filed for bankruptcy. The Wirecard fraud is considered Germany's equivalent of the Enron fraud in the United States, referred to by some as "Germany's Enron."

In late June, 2020, Wirecard's auditor, Ernst & Young (EY), refused to issue an opinion on Wirecard's financial statements for 2019, announcing that it had been provided false supporting information about account balances and that it could not confirm whether assets on the balance sheet of about $2.1 billion ever existed. After the bankruptcy filing, EY announced that there were clear indications of an elaborate and sophisticated fraud involving multiple parties in various institutions around the world. Subsequently, Wirecard admitted that upwards of a quarter of its balance sheet did not exist.

Wirecard is accused of fraudulently overstating revenue by reporting false sales to inflate revenue and earnings and creating affiliates in Asia that existed in name only. (Wirecard apparently also forged and backdated these contracts.) These Asian affiliates received over $1.5 billion in unsecured loans going back to 2015, which apparently cannot be found. Further, it has been alleged by German prosecutors that Wirecard used these affiliated entities to create fictional revenue that allegedly was deposited in bank accounts that didn't exist.

The monies transferred to the Asian affiliates were supposed to be deposited in escrow accounts in Singapore held by a trustee at Oversea-Chinese Banking Corporation (OCBC), Singapore's second largest bank. EY confirmed these balances with the trustee, who falsely told EY that the monies were on deposit at the bank. EY did no additional work to confirm these balances.

In early spring of 2020, the alleged monies ($2.1 billion) were transferred to a bank in Manila under the supervision of a new trustee, who has since indicated that he never signed any trustee documents and accused Wirecard of identity theft. When EY attempted to verify the deposits in the Manila bank accounts, it was unable to travel to Manila because of travel restrictions at that time due to the coronavirus. It attempted a video call with bank employees, but was not convinced the individuals on the screen were actually bank employees. They appeared to be actors in a studio made to look like a bank branch.

In June, 2020 EY was able to visit the Manila bank seeking authentic documents confirming the $2.1 billion on deposit at the bank. Bank of the Philippine Islands (BPI) informed EY that the documents provided by EY from Wirecard to support the deposits were spurious, and the bank could not provide any information on these deposits.

It was later determined that Wirecard was not reporting its financial results based on International Financial Reporting Standards (IFRS) as it indicated, but instead adjusted its financial reporting results to achieve the overstated and inflated sales and earnings they wanted to report.

In conclusion, the $2.1 billion appears to have been an attempt to hide poor performance in certain divisions of Wirecard and also the result of monies distributed to others and not recorded as disbursements in Wirecard's financial statements.

EXAMPLE

In August of 2009, General Electric settled an SEC complaint related to revenue recognition accounting fraud by paying $50 million to settle the SEC's charges. The SEC alleged that GE used improper accounting methods to increase revenues and earnings to avoid reporting negative financial results.

In 2002, GE changed its accounting for sales of commercial aircraft engine spare parts that improperly increased GE's 2002 net income by $585 million. GE had previously overstated revenue, starting in 1992, by recognizing future revenue for sales of spare parts at the same time aircraft engines were sold. By 2002, the amount of future revenue recognized by GE that had not yet been earned by GE amounted to $1 billion. This $1 billion was accounted for as a deferred asset on the balance sheet. GE management became concerned about the size of the deferred asset in 2002 and improperly changed its accounting for the sale of aircraft engine spare parts in two ways:

- GE removed sales of spare parts from the accounting model used to account for sales of aircraft engines that resulted in an immediate charge to net income of $844 million.
- To offset this $844 million charge and to avoid disclosure of its original improper accounting, GE simultaneously made a second change to the revenue recognition model of another business unit, effectively transferring future revenue (including improper pricing increases) from the sales of spare parts to that business unit. The effect of both of these accounting changes allowed GE to overstate 2002 consolidated net income by $585 million.

Pressure/Motivation – Improve operating results

Opportunity – Management override of controls

Attitude/Rationalization – Excessive interest by management in maintaining earnings trends

EXAMPLE

Both Rite Aid and Ahold Inc. utilized recognizing vendor rebates as revenue in their financial statement frauds.

EXAMPLE

One of the classic, fictitious, revenue cases is the case of MiniScribe in the late 1980s. MiniScribe was a manufacturer of disk drives. It fraudulently misstated revenue using the following practices:

- Packaged bricks in disk-drive cartons. The cartons were counted and included in year-end inventory and were then shipped to a company leased warehouse and recorded as sales
- Shipped and reshipped defective goods recognizing revenue for each shipment
- Shipped product to customers that the customers had not ordered, recognized revenue for these shipments and recognized the returned goods in a subsequent period

Pressure/Motivation – Hide the loss of customers

Opportunity – Principal owners participated in the fraud

Attitude/Rationalization – Excessive interest by management in maintaining earnings trends to maintain the price of the stock

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2. **Overstating revenue.** Examples include:

   – Recognizing revenue when inventory is shipped having a right of return provision without estimating the expected returns

   – Recording refunds or credits (purchase returns) from suppliers as revenue

   – Re-invoicing past-due receivables to become current rather than writing off uncollectible amounts

   – Difficulty collecting recorded receivables from customers

   – Understating estimates of sales returns, sales discounts, warranty reserves, and uncollectible receivables

   – Selling tangible assets for a gain and classifying the gain as recurring revenue

   – Recognizing revenue "gross" as a principal when the company was acting as an agent and should have recognized revenue on a "net" basis

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EXAMPLE

Groupon, Inc. is an ecommerce marketplace that connects merchants to consumers by offering goods and services at a discount. Groupon planned an initial IPO in 2012 and filled its proxy statement with the SEC. In its financial statements, Groupon reported revenue significantly higher than it should have. Groupon recognized the price it received from customers at gross amounts rather than the net amount it earned from merchants after remitting payments to these merchants providing the coupons. Groupon did not have inventory risk, collection risk, or performance risk that is required for a company to recognize the gross amount of the transaction. Instead, Groupon should have recognized revenue at the net amounts after payments to these merchants.

Groupon was forced to restate their prior year's recorded revenue from $713 million to $312 million. While the restatement had no bottom-line impact, its revenue per customer ($79 to $35) and revenue per coupon ($24 to $10) was significantly less, making Groupon's IPO less attractive that it would have been.

Pressure/Motivation – Issuing an IPO

Opportunity – Management approved the misleading accounting

Attitude/Rationalization – Misleading accounting will not be disclosed

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3. **Understating revenue.** Examples include:

   – Not recording sales or understating sales that have occurred

   – Delaying sales recognition to reduce income taxes in the current year

   – Closing the books early before year-end to reduce the amount of revenue recognized in the current year

4. **Premature revenue recognition.** Examples include:

   – Leaving the books open at the end of the accounting period and recognizing the next period sales in the prior period

   – Recording sales for inventory shipped on consignment

   – Recording sales when the customer is not required to pay until the inventory is resold to a third party

   – Channel stuffing is the process of pumping up sales, normally at year-end, by offering deep discounts, extended payment terms or other incentives to buy quantities of product that far exceed customer needs

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EXAMPLE

Tesco PLC, the world's second-largest retailer after Wal-Mart Stores Inc., reported in 2015 that it overstated profits by recognizing revenue prematurely in its 2013/2014 fiscal year financial statements. The amount of the overstatement exceeds $400 million. PWC, in its prior audit report, warned that the Company's commercial revenue was at risk of manipulation due to weaknesses in the Company's internal controls. The primary issue centers around Tesco recognizing vendor rebates from suppliers in different periods than when they were earned.

Pressure/Motivation – Improve opportunities to receive incentive compensation bonuses

Opportunity – Management approved the misleading accounting, weak internal controls

Attitude/Rationalization – Misleading accounting will not be disclosed

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EXAMPLE

In October of 2002, the Wall Street Journal reported Bristol-Myers Squibb, after insisting for months that its accounting of excess sales to wholesalers was proper, said it would restate sales and earnings for at least the past two years.

The correction resulted from an investigation by the SEC and the U.S. Attorney in New Jersey into whether the company had improperly inflated sales and profits by offering discounts to customers, who then purchased drugs far in excess of patient needs during 2000 and 2001. These drugs had an expiration date, and drug store chains and others returned millions of dollars of product because it could no longer be sold. The total restatement approximated $2 billion.

Pressure/Motivation – Not recognizing losses associated with channel stuffing, results consistent with public statements

Opportunity – Management approved the misleading accounting

Attitude/Rationalization – It is in the best interest of management and stockholders

Improper Revenue Recognition Red Flags

Red flags associated with improper revenue recognition include:

- Revenue and earnings growth inconsistent with that of competitors or the industry as a whole
- Revenue and earnings increasing while operating cash flow is decreasing or negative
- Significant increase in revenue near year-end with related parties or new customers
- Significant increase in sales to specific customers contrary to recent experience
- Receivables and inventory growth greater than sales growth
- Existence of side agreements with terms and conditions different from normal business practices
- Significant unusual inventory returns after year-end for sales recorded in the prior accounting period
- Increase or decreases in reserve accounts not supported by changes in operating activity
- Access to the organization's sales/receivables master file is not restricted allowing anyone to add or make changes to the information
- Significant new sales to related parties
- Existence of top-side entries made after closing that materially result in an increase in sales and earnings
- Acquisition or merger negotiations taking place

IMPROPER ASSET RECOGNITION OR VALUATION

This topic references two types of fraudulent financial statement schemes:

1. Improper asset recognition
2. Improper valuation of assets

Improper Asset Recognition

Generally, fraudulent schemes in the asset area are due to:

- **Misappropriation of assets** – We will look more closely at the topic of occupational fraud, but at this time, reference AU-C 240's, *Consideration of Fraud in a Financial Statement Audits*, discussion of the misappropriation of assets.

  Misappropriation of assets involves the theft of an entity's assets and it often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management, who is usually better able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including the following:

  – *Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts from written-off collections to personal bank accounts)*

  – *Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, or colluding with a competitor by disclosing technological data in return for payment)*

  – *Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for approving payment at inflated prices, or payments to fictitious employees)*

  – *Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party)*

- **Fictitious assets** – The recording of fictitious assets does not have a cash or payable credit. Often the false transaction is recorded as a debit to the asset and a credit to a paid-in capital account or sometimes an expense account. Fictitious documents are created to support the asset purchase and the fictitious asset is added to other related assets and accounted for accordingly. Examples of assets that can be overstated in this manner include receivables, plant and equipment, and investments. Special note should be made for assets acquired from related parties.

EXAMPLE

Chambers Development, a waste hauler and operator of landfills over-capitalized costs associated with developing landfills, including rent, maintenance, engineering, legal, and interest costs. Instead of basing capitalized costs on actual includable expenditures under GAAP, management determined the amounts by "forcing" income statement expenses to equal a desired percentage of revenue and then dumping the excess into the cost of landfills. Another tactic used by Chambers was the improper continuation of interest capitalization for assets that were either placed in service or substantially complete.

Over a two-year period, these practices converted losses of $57.1 million to $61.5 million in profits.

Pressure/Motivation – Present net income for stock price and lending purposes

Opportunity – Management approved the misleading accounting, weak internal controls

Attitude/Rationalization – It is in the best interest of management and stockholders

- **Misclassification** of a long-term asset to a current asset used to inflate current asset balances. Examples include:
  - Intangible assets (customer lists, exclusive distribution agreement, trademarks, non-compete agreements) which have a longer term value are classified as current assets
  - Intangible assets classified as current assets that have long expired or have no value to the company
  - Transactions with related parties that are more form than substance used to inflate current assets (receivables that are not collectable, for example)
  - Re-invoicing past-due receivables to make them appear to be current
  - Recording the purchase of equipment as the purchase of supplies and recording the supplies as a current asset

Improper Valuation of Assets

Generally accepted accounting principles (GAAP) has valuation accounting and disclosure guidance for 11 difference asset classes:

- Topic 305 – Cash and Cash Equivalents
- Topic 310 – Receivables
- Topic 320 – Investments-Debt and Equity Securities
- Topic 321 – Investments-Equity Securities
- Topic 323 – Investments-Equity Method and Joint Ventures
- Topic 325 – Investments-Other
- Topic 326 – Financial Instruments-Credit Losses
- Topic 330 – Inventory
- Topic 340 – Other Assets and Deferred Costs
- Topic 350 – Intangibles-Goodwill and Other
- Topic 360 – Property, Plant, and Equipment

Note that many of the asset classes above are required to be stated at their **fair values**. Fair value is defined in Topic 820, *Fair Value Measurement*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Valuation techniques used to measure and recognize fair value include market approach, income approach, and replacement cost approach.

Topic 820 establishes a hierarchy (fair value hierarchy) of inputs based on whether they are observable (external and verifiable) or unobservable (internally generated). Observable inputs are difficult to manipulate by a fraudster. Unobservable inputs on the other hand, because they are generally internally generated, can have considerable subjectivity to them and be subject to manipulation by a fraudster. Note, ASU 2018-13, *Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement,* amends and updates Topic 320 with increased disclosure for certain unobservable inputs – effective for fiscal years beginning after December 15, 2019.

We should also note that Topic 815, *Derivatives and Hedging,* requires that derivatives be valued at fair value on the balance sheet. Since derivatives can be traded outside of an open market structure (traded OTC) and their value is linked to an underlying asset, it may be difficult to obtain observable fair values to report. As a result, these valuations are subject to manipulation if the incentive and opportunity presents itself. Fannie Mae is a classic example of this type of manipulation.

EXAMPLE

The **Federal National Mortgage Association (Fannie Mae)** is a publicly held, for-profit corporation, legislated into existence by Congress and operating with a congressional charter to help lower- and middle-income Americans buy residential housing. Fannie Mae does not originate mortgages, but instead guarantees mortgage payments or buys mortgages outright. They receive a fee for guaranteeing the payments on mortgages and mortgages they buy. They traditionally resell to investors in the form of mortgage-backed securities.

As Fannie Mae grew, it chose to hold many of the mortgage-backed securities on its own, which dramatically increased earnings. The increase in earnings resulted from the spread between the lower cost of the individual mortgages and the higher market value of diversified mortgage portfolios. To protect its exposure to interest rate changes, Fannie Mae began investing in derivatives to hedge its downside exposure. Unfortunately, its management of its derivatives risk was poor, and it generated billions of dollars of fair value losses. Fannie Mae left these losses on the balance sheet as assets and did not reclassify the fair value losses as a reduction of earnings on the income statement.

The overstatement has reached $11 billion.

Pressure/Motivation – Improve operating performance, increase earnings

Opportunity – Poor oversight by regulators

Attitude/Rationalization – Confident they will not get caught

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Asset classes where unobservable inputs are frequently used include:

- Value of future contracts
- Asset impairments based primarily on organization-specific use assumptions and cash flow predictions
- Derivatives that are infrequently or never traded
- Investments in nonpublic entities
- Right-of-use lease impairments

- Goodwill impairment based primarily on organization-specific valuation techniques
- Reporting unit, if fair value is based on the organization's internal valuation techniques
- Property, plant, and equipment up for sale when there is not an active market for the assets

Due to the subjective nature of many of these valuations, fraud risk is higher in these situations. **Misstated/overstated asset valuations** are developed to improve the financial condition of the balance sheet or to improve financial coverage ratios. The schemes are more extensive in this area due to the use of subjective estimates to create asset valuations.

Inventory – Inventory is stated at lower of cost or net realizable value when priced using FIFO or average costing methods and lower of cost or market when using the LIFO costing method. The variables that a fraudster can manipulate in the inventory area include:

- Manipulating the physical inventory count
- Inflating costs to price out the inventory
- Not reducing inventory as sales are made
- Not writing off obsolete inventory
- Overstating the inventory's net realizable value or market value
- Creating nonexistent inventory through the use of false documents supporting their existence

Failure to properly value inventory results in inventory and current assets overstatement and incorrect charges to cost of sales. Depending upon where the fraudster puts the credit associated with an inventory overstatement, other accounts such as sales may also be fraudulently presented.

EXAMPLE

Phar-Mor a discount drug store chain, now out of business, committed a massive inventory fraud to maintain its stock price and achieve certain incentive bonuses for its executive officers. The basic scheme was to debit inventory and credit sales each quarter for five years in order to meet earnings targets. As the result of these fraudulent inventory transactions, gross profit increased well beyond industry norms but neither the outside investors in Phar-Mor nor its auditors (Coopers) were alarmed and the unusual and unexpected gross profit results.

Pressure/Motivation – Maintain the stock price and achieve incentive bonuses for executive officers

Opportunity – CEO and CFO involved in the fraud; weak external audits

Attitude/Rationalization – Confident they will not get caught; best interest of management

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EXAMPLE

In January 2013, Caterpillar Inc. announced that it had uncovered "deliberate, multiyear, coordinated accounting misconduct" at a wholly owned subsidiary of a recent China-based acquiree. Based on a post-acquisition physical inventory count, the Company discovered discrepancies between the inventory recorded in the subsidiary's accounting records and actual physical inventory. This and other misstatements prompted Caterpillar to take noncash charge of about $580 million.

Pressure/Motivation – Improve performance to increase the acquisition price

Opportunity – Little independent oversight of operations

Attitude/Rationalization – Acquiree owners benefit

Accounts receivable – Accounts receivable is reported at its net realizable value – the amount of the recorded accounts receivable less any amounts not expected to be collected (AR less an allowance for credit losses). Accounts receivable fraud is often a by-product of revenue fraud as we discussed earlier. Fictitious revenue is often supported by fictitious accounts receivable as the journal entry is debit accounts receivable and credit revenue or sales. Even if an allowance for credit losses is established for the fictitious accounts receivable, the difference between the fraudulent accounts receivable and the allowance for credit losses results in an overstatement of accounts receivable and current assets.

From a valuation perspective, if the receivables or a portion of the receivables are impaired or uncollectable, and the impairment or uncollectable amounts are not recognized, then again an overstatement of accounts receivable and current assets results.

Business combinations – Topic 805, *Business Combinations*, requires that when Company A acquires Company B, the net assets of Company B are transferred to Company A at their individual fair values. This includes both tangible and intangible assets. Any excess of the acquisition price over the value of the net assets acquired in a business combination is recognized as goodwill.

A fraudster has various opportunities to manipulate the business combination results. For example:

- Allocating the acquisition price to the net assets acquired not based on their individual fair values but instead based on the allocation that will provide a maximum tax benefit.
- There may be little value to goodwill due to the acquirer overpaying for the acquiree and, if this is the case, goodwill is overstated until eventually being written off.
- Establish acquisition-based reserves (liabilities that will reduce goodwill on the acquisition date) that are not needed but can be reduced in the future to improve future earnings.
- Understating the value of certain net assets acquired, then selling these assets in the future, generating excessive gains and recognizing these gains as recurring revenue (Tyco).

EXAMPLE

Cendant Corporation was created in December 1997 through the merger of HFS, Inc. and CUC International, Inc. CUC's business included membership-based and Internet-based consumer services such as auto, dining, shopping and travel "clubs." Members were marketed through its Comp-u-Card division. HFS controlled franchise operations for several well-known hotels, real estate brokerage, car rental, and tax preparation businesses.

The merger was accounted for as a pooling of interests (now prohibited), which combines the previous carrying values of the merging entities. It was the operations of CUC that were later found to be fraudulent.

The SEC's enforcement action alleged a "massive fraudulent reporting scheme" spanning more than 12 years before it was exposed in 1998 – the purpose being to inflate earnings to meet analysts' expectations.

Each year, senior management at CUC would identify so-called "opportunities," a term for methods available to inflate earnings. There were four major categories of "opportunities."

- Manipulating (i.e., accelerating) recognition of membership sales revenue
- Understating or eliminating liability accounts relating to membership commissions payable and cancellations
- Overstating merger and purchase reserves and then reversing them as revenue or a reduction of expenses
- Recording asset writedowns – some totally fictitious – and booking them against the excess merger reserves so that future depreciation expense would be reduced. In some cases, proper writedowns were shifted to the wrong periods.

The impact on earnings during the fiscal years ended 1/31/96, 1/31/97 and 12/31/97 (change in year-end) totaled over $500 million, of which more than half was in the year ended 12/31/97.

The scheme, led by CUC's senior management, went at least as far back as 1988. To inflate interim quarterly results, "top-side" adjustments were simply inserted in spreadsheets used at corporate to prepare consolidated financial statements. As a result, quarterly financial statements reflected bogus entries never even recorded on CUC's books. In one three-year period, these entries overstated earnings by $294 million.

At year-end, the bogus amounts had to be recorded on the books to avoid detection by the outside auditors. Initially, this was accomplished by improperly accelerating membership revenue and deferring or ignoring related liabilities for commissions and cancellations. Over time, in order to conceal the debits needed to balance the inflated profits, CUC began to rely more and more on inflated merger-related reserves established from a series of acquisitions. CUC essentially had a "feeding frenzy," acquiring companies to create reserves that could be used to conceal expenses and losses of CUC. The SEC noted that, in devising the amount of bogus reserves to record, managers sometimes simply doubled the amounts that had been calculated as CUC's true costs. In other cases, divisional managers were simply told what to book as reserves without being consulted on what actual costs were.

The scheme was made harder to trace by funneling much of the manipulation through intercompany accounts at smaller divisions that were not fully audited. Eventually, only massive reserves could sustain the scheme, propelling CUC to reopen merger talks with HFS. The merger was accomplished just before year-end in 1997. The excess reserve recorded on the merger was used, among other purposes, to conceal a $75 million asset writedown of goodwill, receivables, and other assets of CUC at December 31, 1997.

It is interesting to note that the excess reserves in this case related to mergers and acquisitions accounted for as poolings. Since no goodwill was recorded, the offset to the reserve hits earnings, as the SEC's Enforcement Release states, "The charges for a reserve so established in connection with a business combination accounted for as a pooling of interests appear in the entity's income statement as a separate expense item designated as unusual or transaction-related charges, to distinguish them from the entity's usual operating expenses…" For example, in CUC's report on Form 10-K for its fiscal year ended 1/31/97, this line item was designated 'merger, integration, restructuring, and litigation charges associated with business combinations,' while one year later, on Cendant's postmerger financial statements, it was called 'merger-related costs and other unusual charges.'

Pressure/Motivation – Improve performance to increase the acquisition price

Opportunity – Little independent oversight of operations; poor internal controls

Attitude/Rationalization – CUC owners benefit by achieving a higher sale price for CUC

Asset impairments – Asset impairment guidance is found in Topic 360, Property, Plant, and Equipment. This guidance indicates that long-lived assets held and used for operating purposes should be tested for impairment when event or circumstances indicate that their carrying values are not recoverable. In order to understand why asset impairments carry fraud risk, the following triggering events must be evaluated to determine the likelihood of recovering the asset value:

- A significant decrease in the market price of the asset (group)
- A significant adverse change in the extent or manner in which the asset (group) is used or its physical condition
- A significant adverse change in legal factors or the business climate, such as a recession
- Costs that significantly exceed the original amount to acquire or construct the asset
- A current period operating or cash flow loss combined with a history of operating or cash flow losses, or a projection or forecast demonstrating continuing losses associated with the use of the asset (group)
- A current expectation that, more likely than not, the asset will be sold or disposed of significantly before the end of its previously expected useful life

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EXAMPLE

DirectTV Group took a $1.47 billion writedown after deciding to use several new satellites for high-definition TV broadcasting rather than for their original intended use in an Internet service. This change in use resulted in the impairment loss.

The occurrence of these triggering events, causes an organization to perform a two-part asset impairment test:

1. Compare the asset's carrying value to the future undiscounted cash flows expected to be generated through the use of the asset. If the cash flows are lower than asset's carrying value, then the asset is impaired.

2. The impairment loss to recognize is the difference between the asset's carry amount and its fair value.

Often, the fair value of long-lived assets is based on either an organization-specific appraisal or the present value of a probability-weighted range of possible cash flows. The result is an unobservable, Level 3 fair valuation often leading to inconsistency and a subjective measurement.

In the asset impairment area, fraudulent activity can occur in the following ways:

- The triggering event or circumstance is ignored or considered immaterial
- Prediction of future undiscounted cash flows is organization-specific based on expected use and can easily be manipulated
- Fair value is normally an unobservable input based on organization assumptions and also can be easily manipulated

Goodwill impairments – Topic 805, *Business Combinations*, defines goodwill as the excess of the consideration transferred (fair value) plus the fair value of any non-controlling interest in the acquiree over the fair value of the net assets acquired. Under Topic 350, *Intangibles – Goodwill and Other*, goodwill in the past has not been amortized. Instead, it is reviewed for impairment at least annually. Other intangible assets with indefinite lives – i.e., those that contribute to cash flows directly or indirectly for an indefinite period – fall under essentially the same rules as goodwill.

The goodwill impairment test can be performed any time during the year but may have to be performed again if a change in circumstances before the next scheduled annual test indicates a potential problem.

The impairment testing process for goodwill starts by "matching up" goodwill with the reporting unit to which it relates. A reporting unit is an operating segment, or one level below an operating segment, for which discrete financial information is available and is regularly reviewed by management.

The reporting organization has the option to:

- Assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, **OR**
- Bypass the qualitative assessment and proceed directly to performing the goodwill impairment test. (The organization may resume performing the qualitative assessment in any subsequent period.)

If a reporting organization opts to assess qualitative factors and determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then the organization is required to perform the goodwill impairment test. Otherwise, goodwill is presumed to not be impaired and the goodwill impairment test is not required.

The goodwill impairment test consists of comparing the fair value of the reporting unit containing goodwill to its carrying value. If the fair value is less than the carrying value, then the recorded goodwill amount is reduced for the difference not to go below zero. ASU No. 2017-04, *Intangibles-Goodwill and Other* (Topic 350): *Simplifying the Test for Goodwill Impairment*, allows for a one-step impairment test. SEC filers should adopt this ASU for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019.

Note: All other assets in a reporting unit are tested for impairment before goodwill is. This includes any writedown of receivables, inventory, investments, etc., as well as long-lived assets tested under Topic 360.

EXAMPLE

Devon Energy is a leading independent energy company engaged in finding and producing oil and natural gas. Based in Oklahoma City and included in the S&P 500, Devon operates in several of the most prolific oil and natural gas plays in the U.S. and Canada with an emphasis on a balanced portfolio. The Company is the second-largest oil producer among North American onshore independents.

While Devon Energy has not been accused of any fraudulent financial statement activity, the following 2015 goodwill note disclosure illustrates the potential for financial statement fraud when evaluating the scope of goodwill impairments.

Devon performs an annual impairment test of goodwill at October 31, or more frequently if events or changes in circumstances indicate that the carrying value of a reporting unit may not be recoverable. Sustained weakness in the overall energy sector driven by low commodity prices, together with a decline in EnLink's unit price, caused a change in circumstances warranting an interim impairment test of EnLink's reporting units. Furthermore, due to the continued impact of declining commodity prices and EnLink unit price, an update was performed as of December 31, 2015. As a result of these tests, noncash goodwill impairments of $1,328 billion were recorded related to EnLink's Texas, Louisiana and Crude and Condensate reporting units in 2015.

In the fourth quarter of 2014, as a result of its annual impairment test of goodwill, Devon concluded the implied fair value of its Canadian goodwill was zero and wrote off the remaining goodwill amount of $1,941 billion. This conclusion was largely based on the significant decline in benchmark oil prices, particularly after OPEC's decision not to reduce its production targets that was announced in late November 2014. Devon's Canadian goodwill was originally recognized in 2001 as a result of a business combination consisting almost entirely of conventional gas assets that Devon no longer owns.

EnLink's customer relationships were also evaluated for impairment due to the factors in the aforementioned goodwill impairment analysis. Level 3 fair value measurements were utilized for the impairment analysis of definite-lived intangible assets, which included discounted cash flow estimates, consistent with those utilized in the goodwill impairment assessment. This assessment resulted in a $223 million noncash impairment related to EnLink's Crude and Condensate customer relationships in 2015.

Improper Asset Recognition or Valuation Red Flags

- Cash flows from operations less than reported earnings or cash flow from operations is negative while the organization is reporting positive earnings and increasing earnings growth
- Changes in the valuation techniques and assumptions used to measure the fair value of assets
- Increasing use of unobservable inputs for fair value measurement
- Analytic results that differ from industry in asset classes such as inventory, accounts receivables, business combinations, asset impairments, goodwill impairments, as well as reported revenue and earnings amounts
- Changes in inventory pricing assumptions from prior periods
- Allowance for credit losses not increasing proportionate to receivable increases

- Significant new assets obtained from related parties
- Merger or acquisition discussions currently taking place
- Changes in the economy or industry the organization operates in causing decreasing customer demand and bankruptcies
- Assets measured based on significant organization estimates that are not observable

CONCEALED LIABILITIES AND EXPENSES

An organization may understate or conceal expenses or debt in an attempt to overstate or manage revenue. Examples may include:

- Recording and classifying expenses as assets – capitalizing expenses (note WorldCom, Rite Aid)
- Placing debt in unconsolidated off-balance sheet entities (Enron)
- Reporting debt incurred as revenue
- Simply not recording expenses or debt as incurred
- Increased involvement with related parties
- Failing to record or disclose contingent liabilities
- Overstate liabilities by establishing cookie jar reserves

EXAMPLE

As stated previously, Adelphia Communications, CEO John Rigas and his three sons secretly secured loans for $2.3 billion from Adelphia family partnerships, which were all guaranteed by Adelphia Communications.

As stated in the SEC complaint:

Between mid-1999 and the end of 2001, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, James P. Rigas, and James R. Brown, with the assistance of Michael C. Mulcahey, caused Adelphia to fraudulently exclude from the Company's annual and quarterly consolidated financial statements over $2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia's off-balance sheet, unconsolidated affiliates. Failure to record this debt violated GAAP requirements and laid the foundation for a series of misrepresentations about those liabilities by Adelphia and the defendants, including the creation of: (1) sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities, and (2) misleading financial statements by giving the false impression through the use of footnotes that liabilities listed in the Company's financials included all outstanding bank debt.

"Cookie Jar" Accounting Schemes in General

"Cookie jar accounting" refers to any of a variety of accounting practices that involve deliberately under-reporting earnings in an earlier period ("filling the cookie jar") in anticipation of opportunities and incentives to overreport earnings in a later period ("taking cookies from the jar"), all without detection. To execute a cookie jar accounting scheme, a company:

- Fills the cookie jar when it can (i.e., deliberately understates reported income for the period); and

- Withdraws from the cookie jar when it must (i.e., deliberately overstates reported income for the period).

Cookie jar accounting schemes may be undertaken for any of a variety of reasons:

- **To reduce period-to-period volatility in reported earnings**. This reduces investors' perception of risk, and therefore enhances the organization's share price for a given average level of periodic earnings. Managers often have economic and other incentives to maximize the entity's share price.

- **To portray a pattern of steady earnings growth**. This increases investors' expectations of future cash flows, and therefore enhances the entity's present share price. Again, managers often have economic and other incentives to maximize the organization's share price.

- **To ensure the awarding of performance-based compensation to management even in periods of low performance**. By "storing" earnings that exceed bonus criteria in high-performance periods, the "stored" earnings can be used to enhance reported earnings in low-performance periods when bonus criteria would otherwise not be met.

- **To ensure that managers consistently "make their budget numbers."** Adverse career consequences – not necessarily economic in nature – may await managers who fail to do so.

Cookie jar accounting is wrong because it:

- Obscures true period-to-period earnings volatility and therefore masks the actual risks that investors bear

- Encourages a culture of deception in financial reporting

- Manipulates multiple accounting periods

There are at least three distinct types of cookie jar accounting schemes.

1. Under the first type:

   - When "excess" earnings are available, the reporting organization **fabricates accounting events/transactions** that result in:

     - Debits to an income statement account

     - Credits to a balance sheet account (these credits are thus "stored" for future use)

- During periods with lower-than-desired earnings, the organization fabricates accounting events/transactions that result in:
    - Debits to the previously-credited balance sheet account (i.e., draw upon the "stored" credits)
    - Credits to an income statement account

2. Similar to the first type of cookie jar accounting scheme, a second type works as follows:
    - When "excess" earnings are available, the reporting organization **artificially increases the amounts recorded for accounting events/transactions** that result in:
        - Debits to an income statement account
        - Credits to a balance sheet account (the excess credits are thus "stored" for future use)
    - During periods with lower-than-desired earnings, the organization "trues up" balance sheet account balances by:
        - Debiting the previously-credited balance sheet account (i.e., draw upon the "stored" credits)
        - Crediting an income statement account
        - Here is a third type of cookie jar accounting scheme:
    - When "excess" earnings are available, the reporting organization **neglects to record events/transactions** that would result in:
        - Debits to a previously-credited balance sheet account
        - Credits to an income statement account
    - During periods with lower-than-desired earnings, the organization records the previously unrecorded accounting events/transactions.

EXAMPLE

In July 2009, the SEC charged a former chief accounting officer of Beazer Homes USA, Inc. with conducting a multiyear, fraudulent, earnings-management scheme and misleading Beazer's outside auditors and internal Beazer accountants in order to conceal his wrongdoing.

The SEC alleged that Beazer's former chief accounting officer:

- Fraudulently decreased Beazer's reported net income by recording improper accounting reserves during certain periods between 2000 and 2005
- Began reversing these improper reserves beginning in the first quarter of fiscal year 2006 in order to offset Beazer's declining financial performance

- Took affirmative steps to conceal the fraud from Beazer's outside auditors and internal Beazer accountants

The former chief accounting officer also worked additional, different schemes. Under its accounting policies, Beazer recorded revenue and profit on the sale of a house after the close of the sale of that house to a homebuyer. In the journal entries to record the sale, Beazer typically reserved a portion of its profit earned on the house. This reserve, called a "house cost-to-complete" reserve, was established to cover any unknown expenses that Beazer might incur on the sold house after the close, such as minor repairs or final cosmetic touchups.

Beazer's policy was to reverse any unused portion of the house cost-to-complete reserve within four to nine months after the close, taking any unused portion into income at that time. Although creation of such a house cost-to-complete reserve is proper, the former chief accounting officer fraudulently utilized these reserves to manage Beazer's earnings. Specifically, in various quarters between 2000 and 2005, he over-reserved house cost-to-complete expenses in order to defer profit to future periods (another scheme of the second type, as explained above). He then took steps to maintain these reserves beyond the typical four to nine months and until increased earnings were required in future periods (a scheme of the third type).

Pressure/Motivation – Manage earnings to conceal declining financial performance

Opportunity – Chief Accounting Officer involved

Attitude/Rationalization – Enables the company to continue operating

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EXAMPLE

Another example of using cookie jar reserves is Nortel Network Corp, a Canadian company. Nortel had grown to become an international power manufacturing and delivering communications equipment throughout the world. Nortel employed 94,000 people worldwide prior to the alleged fraud taking place. The Wall Street Journal reported that Nortel established reserve accounts that were released into earnings to enable employees to achieve bonuses based on earnings. These accounting reserves, $80 million, were established in one period when losses were occurring and then reduced in the next period as the bonus plan was effective.

In the years prior to the alleged accounting fraud, Nortel lost $197 million, $2.9 billion, 27.4 billion, and 3.6 billion respectively.

The Nortel executives involved in this alleged accounting fraud were found not guilty by an Ontario trial judge. The judge concluded that “The accused are presumed innocent. The burden of proof in on the prosecution and in my view, that burden was not met.” Based on these allegations, the company collapsed and went out of business.

Red Flags of Concealed Liabilities and Expenses

- As noted earlier, negative operating cash flows or trends of declining operating cash flows while reported revenue and net income is growing
- Unusual increases in property and equipment accounts
- Lower than anticipated expenses

- Purchases from related parties
- Extensive related party transactions
- Extensive use of unconsolidated off-balance sheet entities
- Again, nonfinancial management involved in the selection of accounting principles the organization should follow or involved in the determination of significant estimates
- Reported gross profit higher than those in the industry
- Decreasing accounts payable and accrued expense ratios over time
- Merger or acquisition negotiations taking place

IMPROPER FINANCIAL STATEMENT DISCLOSURES

Entities are required to disclose sufficient information concerning operating results and financial statement performance necessary to prevent the financial statements from being misleading. When improper financial statement disclosures take place the result is to mislead users and investors concerning the economic results and performance of a reporting organization. **Fraudulent financial statement disclosures have occurred in the following areas**:

- Not disclosing the existence of loan covenant restrictions
- Not disclosing the existence of contingent liabilities or guarantees made
- Not disclosing the fair values of financial instruments that have become impaired
- Not disclosing subsequent events that occur after year-end that might include legal settlements, impaired assets, or economic events that could negatively impact the reported results
- Not disclosing the existence of and the activity with related parties
- Not disclosing or reflecting in the financial statements the results and impact of a change in accounting principle or a change in an accounting estimate in order to present misleading financial statements
- Committing financial statement fraud to overstate or understate earnings and concealing the financial statement fraud by not disclosing it

An example of a misleading financial statement disclosure is the following Enron note from 2000. This note is purposely misleading by not disclosing the thousands of off-balance sheet entities used by Enron to overstate revenues by billions of dollars nor does the disclosure identify numerous related party situations between Enron executives and these off-balance sheet entities.

EXAMPLE

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (i) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interest for the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investment and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investments and price risk management activities. In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions, and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron.

Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to the Related Party.

In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for $30 million cash and a $70 million note receivable that was subsequently repaid. Enron recognized gross margin of $67 million on the sale.

In 2000, the Related Party acquired, through securitizations, approximately $35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed $17.5 million in cash. Subsequently, Enron sold a portion of its interest in the partnership through securitizations. See Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a $36 million loss to Enron.

In 1999, the Related Party acquired approximately $371 million of merchant assets and investments and other assets from Enron. Enron recognized pretax gains of approximately $16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million.

The following note is an example of the disclosure impact of not disclosing a financial statement fraud in the past when it is discovered in the future:

TYCO INTERNATIONAL LTD. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Restatement and Summary of Significant Accounting Policies Basis of Presentation – The Consolidated Financial Statements include the consolidated accounts of Tyco International Ltd., a company incorporated in Bermuda, and its subsidiaries (Tyco and all its subsidiaries, hereinafter "we," the "Company" or "Tyco") and have been prepared in United States dollars, and in accordance with Generally Accepted Accounting Principles in the United States ("GAAP"). As described in Note 11, CIT Group Inc. ("CIT"), which comprised the operations of the Tyco Capital business segment, was sold in an initial public offering ("IPO") in July 2002. Consequently, the results of Tyco Capital are presented as discontinued operations. References to Tyco refer to its continuing operations, with the exception of the discussions regarding discontinued operations in Note 11. The continuing operations of Tyco represent what was referred to as Tyco Industrial in prior filings.

Investigation – With the arrival of new senior management, the Company has engaged in a number of internal audits aimed at determining what, if any, misconduct may have been committed by prior senior management. An initial review of prior management's transactions with the Company was conducted by the law firm of Boies, Schiller & Flexner LLP. The details of their findings were made public in a Form 8-K filed on September 17, 2002. In July 2002, our new CEO and our Board of Directors ordered a further review of corporate governance practices and the accounting of selected acquisitions. This review has been referred to as the "Phase 2 review."

The Phase 2 review was conducted by the law firm of Boies, Schiller & Flexner LLP and the Boies firm was in turn assisted by forensic accountants. The review received the full cooperation of Tyco's auditors, PricewaterhouseCoopers LLP, as well as Tyco's new senior management team. The review included an examination of Tyco's reported revenues, profits, cash flow, internal auditing, and control procedures, accounting for major acquisitions and reserves, the use of nonrecurring charges, as well as corporate governance issues such as the personal use of corporate assets and the use of corporate funds to pay personal expenses, employee loan, and loan forgiveness programs. Approximately 25 lawyers and 100 accountants worked on the review from August into December 2002. In total, at considerable cost, more than 15,000 lawyer hours and 50,000 accountant hours were dedicated to this review. The review team examined documents and interviewed Tyco personnel at more than 45 operating units in the United States and in 12 foreign countries.

The results of the Phase 2 review were reported by the Company in a Form 8-K furnished to the SEC on December 30, 2002.

Restatement – As previously disclosed, we have been engaged in a dialogue with the staff of the Division of Corporation Finance of the U.S. Securities and Exchange Commission (the "Staff") as part of a review of our periodic filings. We believed that we had resolved the material accounting issues at the time of the original filing of our Form 10-K for the year ended September 30, 2002. Subsequent correspondence and discussions with the Staff, principally regarding the method of amortizing contracts acquired through our ADT dealer program as well as the accounting for amounts reimbursed to us from ADT dealers, coupled with issues related to prior periods identified during our intensified internal audits and detailed operating reviews in the quarter ended March 31, 2003 have led us to restate our consolidated financial statements for the quarters ended March 31, 2003 and December 31, 2002, and for the fiscal years ended September 30, 2002, 2001, 2000, 1999, and 1998.

The restatement principally relates to (i) recording charges in the prior years and quarters to which they relate, rather than in the period such charges were initially identified, (ii) a revision in the method of amortization used to allocate the costs of contracts acquired through our ADT dealer program so that the amortization of such costs better matches the pattern of revenue related to such contracts, (iii) a revision in the method of accounting for amounts reimbursed to us from ADT dealers as part of the ADT dealer program to effectively treat such amounts as an integral part of the purchase of the underlying contracts, and (iv) certain other adjustments regarding charges or credits so as to record them in earlier accounting periods to which they relate. Each of these matters are described further below:

Charges Relating to Prior Years Initially Recorded in Fiscal 2002

As disclosed in the Company's previously filed Form 10-K for the fiscal year ended September 30, 2002, the Company identified various adjustments during the fourth quarter of fiscal 2002 relating to prior period financial statements. These adjustments, which aggregated $261.6 million on a pretax basis or $199.7 million on an after-tax basis, were recorded effective October 1, 2001. The adjustments primarily were related to reimbursements from ADT dealers in years prior to fiscal 2002 in excess of the costs incurred, a lower net gain on the issuance of TyCom shares previously reported for fiscal 2001 and adjustments identified both as a result of the Phase 2 review and the recording of previously unrecorded audit adjustments (which were more appropriately recorded as expenses as opposed to part of acquisition accounting). The restatement includes adjustments to reverse the charges recorded in the first quarter of fiscal 2002 and present those charges in the historical periods to which they relate.

Charges Relating to Prior Years and Quarters Recorded in the Quarter Ended March 31, 2003

As disclosed in the Company's previously filed Form 10-Q for the quarter ended March 31, 2003, the Company conducted intensified internal audits and detailed controls and operating reviews that resulted in the Company identifying and recording pretax charges of $434.5 million in that quarter for charges related to prior periods. These charges resulted from capitalizing certain selling expenses to property, plant, and equipment and other noncurrent assets, mostly in the Fire and Security Services segment, and reconciliation items relating to balance sheet accounts where certain account analysis or periodic reconciliations were deficient, resulting in adjustments primarily related to the Engineered Products and Services segment. Additionally, charges related to the correction of balances primarily related to corporate pension and deferred compensation accruals, assets reserve adjustments and other accounting adjustments (i.e., purchase price accounting accruals, deferred commissions, accounting related to leases in the Fire and Security Services and Engineered Products and Services segments). The restatement includes adjustments to reverse the charges recorded in the quarter ended March 31, 2003 and reflect those charges in the historic periods to which they relate.

Method of Amortizing Contracts and Related Customer Relationships

As described elsewhere in this Note 1 to the financial statements, the Company purchases residential security monitoring contracts from an external network of independent dealers who operate under the ADT dealer program. The purchase price of these customer contracts is recorded as an intangible asset (i.e., contracts and related customer relationships), which is amortized over the period of the economic benefit expected to be obtained from the customer relationship. Effective January 1, 2003, and as disclosed in the Company's previously filed Form 10-Q for the quarter ended March 31, 2003, the Company changed its method of accounting for the amortization of the costs of these purchased contracts from the straight-line method to an accelerated method. In addition, the Company revised its estimate of the life of the customer account pool over which the costs of purchased contracts would be amortized from 10 years to 12 years. The change in method of accounting was viewed as inseparable from the change in estimated life, and therefore, the pretax cumulative effect of this charge of $315.5 million was recorded as an increase in amortization expense effective January 1, 2003. The restatement reverses this previously recorded charge and reflects the accelerated amortization method for all historical periods.

Amounts Reimbursed from ADT Dealers

As described elsewhere in this Note 1 to the financial statements, the Company incurs costs associated with maintaining and operating its ADT dealer program, including brand advertising costs and due diligence costs relating to contracts offered for sale to the Company under the ADT dealer program. Dealers pay the Company a nonrefundable amount for each of the contracts sold to the Company representing their reimbursement of such dealer program costs. Prior to fiscal 2002, the Company recognized as an expense reduction the entire amount of such reimbursements from dealers. Commencing October 1, 2001, to the extent that the amount of dealer reimbursement exceeded the actual costs incurred by the Company, the excess was recorded as a deferred credit and amortized on a straight-line basis over 10 years.

As disclosed in the Company's previously filed Form 10-Q for the quarter ended March 31, 2003, the Company changed its method of accounting for these reimbursements from dealers. Pursuant to a recently issued consensus of the FASB's Emerging Issues Task Force (EITF 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration received from a Vendor"), the consideration received by the Company relating to the nonrefundable charge to each dealer for reimbursement of the costs to support the ADT dealer program was presumed to be a reduction in the capitalized intangible asset cost to the Company of acquiring customer contracts. As permitted under EITF 02-16, the Company changed its method of accounting for the amounts received from dealers for reimbursement of the costs to support the ADT dealer program through a cumulative change recorded retroactively to the beginning of the fiscal year. This was reported as a $206.7 million after-tax ($265.5 million pretax) charge for the cumulative effect of change in accounting principle in the Consolidated Statement of Operations for the six months ended March 31, 2003, retroactive to October 1, 2002. The impact on the Consolidated Balance Sheets of the cumulative adjustment was a decrease in net intangible assets of $566.8 million and a decrease in liabilities for the previously deferred nonrefundable charge to dealers of $301.4 million.

The restatement reverses the cumulative effect of the previously recorded change in accounting to report nonrefundable dealer reimbursements as a reduction in the capitalized intangible asset cost to the Company of purchasing customer contracts in each prior accounting period to which such purchases relate, and changes the classification of the portion of such previous charge that represents an impairment of customer contracts and relationships. This impairment charge ($77.0 million pretax) resulted from a further deterioration during the quarter ended March 31, 2003 of future estimated cash flows anticipated from customers primarily in Mexico and certain Latin American countries following the curtailment, and in some instances, the termination of the ADT dealer program in these countries in 2002. This charge is now classified on the fiscal 2003 Consolidated Statement of Operations as an Impairment of Long-Lived Assets.

Other Adjustments

In connection with the decision to reverse the effect of charges relating to prior years and quarters described above, and to record those charges in the fiscal periods to which they relate, the restatement also records the following adjustments, representing timing differences between fiscal periods: (i) reduce the revenue ($90.0 million) and gross margin ($53.0 million) recognized on the sale of capacity on the TyCom network recorded in fiscal 2001 and 2002 and reverse the write-off of $55.0 million of remaining accounts receivable relating to such transaction (ii) reverse $166.8 million of income recognized in connection with the settlement of litigation in fiscal 2001, along with the corresponding value assigned to intangible assets, and reverse the subsequent amount of amortization of the intangible asset as well as the amount of loss attributable to that asset upon disposition in fiscal 2002 of the Healthcare business to which the intangible asset related and (iii) reverse $31.6 million of charges originally recorded during the fourth quarter of fiscal 2002 and reflect this charge in the prior quarters and years to which they relate. These charges relate primarily to intercompany profit, capitalized costs, and account reconciliation issues within the Engineered Products and Services segment. In addition, in connection with the Phase 2 review the Company recorded a balance sheet adjustment of $235.6 million to goodwill and shareholders' equity for the fair value of stock options assumed in connection with the fiscal 2001 acquisition of Mallinckrodt, Inc.

The Company also determined that the pretax charges of $434.5 million recorded in the quarter ended March 31, 2003 described above should have been greater by $71.5 million. The $71.5 million (which relates primarily to workers' compensation and product and general liability insurance accruals) was previously included in the $471.4 million of charges recorded during the quarter ended March 31, 2003, described as Charges Related to Current Period Changes in Estimates. This amount has been reversed and is reflected as part of the restatement discussed above.

In addition to the charges and adjustments discussed above, the Company also identified previously unrecorded obligations relating to compensation arrangements with two members of former senior management, which were funded through split dollar life insurance policies (see Note 17). The Company's obligations under these arrangements were entered into in recognition of services rendered by these officers in prior fiscal periods and were not contingent upon continuing employment. The Company previously expensed the insurance premiums funded under these arrangements of $7.7 million, and $3.8 million in the years ended September 30, 2002, and 2001, respectively, as well as a lump-sum payment of $24.6 million paid to one of the officers upon his termination in fiscal 2002. As part of the restatement the Company has accrued $46.6 million and $70.9 million on our consolidated balance sheets as of September 30, 2002 and 2001, respectively, in connection with these arrangements and reversed the expense for the lump-sum payment recorded in fiscal 2002 related to the terminated executive, as it is now recorded in fiscal years 2001 and 2000.

In addition, it was determined that the cumulative net deferred tax assets associated with the above charges should have been greater by approximately $116 million as of March 31, 2003 and $300 million as of September 30, 2002. The effect of the tax adjustment on previously reported results of operations is to increase net income from continuing operations and net income by $49.6 million, $103.4 million, $75.0 million and $72.0 million for the fiscal years of 2002, 2001, 2000, and fiscal years preceding 2000, respectively.

The Company believes that the restatement addresses all of the significant remaining issues identified as part of the Staff's ongoing review of its periodic reports. We continue to be engaged in a dialogue with the Staff, however, and the review is not yet complete. We are working to resolve the remaining comments that the Staff has made on our periodic filings as expeditiously as possible. We cannot assure you the resolution of the remaining Staff comments will not necessitate further amendments or restatements to our previously filed periodic reports.

Red Flags of Improper Financial Statement Disclosures

- Ineffective board or audit committee oversight
- Reported gross profit and earnings higher than those in the industry
- Extensive related party transactions
- Increased use of off-balance sheet entities
- Economy is declining and the organization is losing customers and market share
- History of not providing adequate financial statement disclosures

Unit

4

Occupational Fraud

LEARNING OBJECTIVE

After completing this section, participants will be able to:

- Describe the Association of Certified Fraud Examiners 2020 Report to the Nations

INTRODUCTION TO ASSET MISAPPROPRIATIONS

The material in this section is based on the Associations of Certified Fraud Examiners (ACFE) 2020 *Report to the Nations*, a global study on occupational fraud and abuse. Occupational fraud is defined as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." The Report describes "occupational fraud" as consisting of three categories:

1. Corruption
2. Asset misappropriation
3. Financial statement fraud

We discuss financial statement fraud in other sections of this program. In this section, we will focus primarily on the topics of corruption and asset misappropriation.

Corruption consists of the following activities:

- Conflicts of interest
  - Purchasing schemes
  - Sales schemes
- Bribery
  - Invoice kickbacks
  - Bid rigging

- Illegal gratuities
- Economic extortion

Asset Misappropriation consists of the following activities:

- Cash
  - Theft of cash on hand
  - Theft of cash receipts including skimming, lapping, or write off schemes
  - Fraudulent disbursements including billing schemes, payroll schemes, expense reimbursement schemes, check and payment tampering, and register disbursements
- Inventory and all other assets
  - Misuse
  - Larceny including asset requisitions and transfers, false sales and shipping, purchasing and receiving, and unconcealed larceny

2020 REPORT TO THE NATIONS

This Report surveyed 2,000 certified fraud examiners (CFEs) and among the questions asked, the most important question probably was "What percentage of revenues do they believe a typical organization loses to fraud each year?" The median response provided by these CFEs is that **an organization loses 5% of their annual revenue to fraud** (loss is more than $4.5 trillion) and the median duration of all the fraud cases in the Report was 16 months. This projects to total global fraud losses of nearly $4 trillion. The median losses for all cases in the Report was $130,000.

Looking at the **three categories of occupational fraud**, the frequency of occurrence and the related medial losses were found to be as follows:

1. Asset misappropriation – 86% of the time with a median loss of $100,000
2. Corruption – 43% of the time with a median loss of $200,000
3. Financial statement fraud – 10% of the time with a median loss of $954,000

Note, some occupational fraud consists of multiple elements accounting for the percent's above and below to be more than 100%.

The **asset misappropriation schemes** that present the greatest risk include:

- Billing – 20%
- Non-cash (assets) – 18%
- Expense reimbursements – 14%

- Skimming – 11%
- Cash on hand – 10%
- Check and payment tampering – 10%
- Payroll – 9%
- Cash larceny – 8%
- Register disbursements – 3%

Corruption schemes vary in type and complexity but the Report makes the following observations:

- The industries with the highest proportion of corruption cases include:
  - Energy
  - Telecommunications
  - Transportation warehousing
- 70% of corruption cases were perpetrated by someone in a position of authority
- 72% of corruption cases were committed by males
- 50% of corruption cases were detected by tips
- Red flags in corruption cases include the following:
  - Individual(s) living beyond their means
  - Individual(s) have unusually close association with vendors/customers
  - Individual(s) having financial difficulties
  - Individual(s) having control issues, unwillingness to share duties
  - Individual(s) have a "wheeler-dealer" attitude
- More than half of all occupational frauds came from these four departments:
  - Operations – 15%
  - Accounting – 14%
  - Executive/upper management – 12%
  - Sales – 11%

Whether asset misappropriation or corruption, fraudsters do everything they can to conceal the fraud they committed. The top four **concealment methods** identified in the Report include:

1. Created fraudulent physical documents – 40%

2. Altered physical documents – 36%

3. Altered electronic documents of files – 27%

4. Created fraudulent electronic document or files – 26%

The Report includes a topic on the detection of occupational fraud. The Report emphasizes that employees are the most likely group to report occupational fraud. **Occupational fraud is initially detected** through the following methods:

- Tip – 43%
- Internal audit – 15%
- Management review – 12%
- By accident –5%
- Account reconciliation – 4%
- External audit – 4%
- Document examination – 3%
- Surveillance/monitoring – 3%
- Notified by law enforcement – 2%
- IT controls – 2%
- Confession – 1%

One of the more unique findings in the Report is the differences in **fraud median losses by industry**:

- Mining - $475,000
- Energy - $275,000
- Real Estate - $254,000
- Telecommunications $ 250,000
- Construction - $200,000
- Health Care - $200,000

- Manufacturing - $ 198,000

The Report also identified what **antifraud controls** were most common in the cases identified. The presence of antifraud controls reduced the magnitude of the fraud losses compared to entities that did not have these antifraud controls:

- External audit of financial statements – 83%
- Code of conduct – 81%
- Internal audit department – 74%
- Management certification of financial statements – 73%
- External audit of internal controls over financial reporting – 68%
- Management review – 65%
- Existence of a tip hotline – 64%
- Independent audit committee – 62%
- Anti-frau policy – 56%
- Employee support programs – 55%
- Fraud training for employees and managers – 55%

Another finding in the Report addresses weaknesses in internal controls that lead to fraud related losses. The Report identified the following weaknesses in internal controls based on findings from the cases identified:

- Lack of internal controls – 32%
- Lack of management review – 18%
- Internal controls were overridden – 18%
- Poor tone at the top – 10%
- Lack of competent personnel in oversight roles – 6%
- Lack of independent checks/audits – 5%

In 85% of the cases in this report, fraudsters displayed at least one of the following behavioral red flags:

- Living beyond their means – 42%
- Had financial difficulties – 26%

- Had an unusually close association with vendors/customers – 19%
- Exhibited control issues; unwilling to share duties and responsibilities – 15%
- Irritability, suspiciousness, or defensiveness – 13%
- Wheeler dealer attitude – 13%
- Had divorce or family issues – 12%

The Report also includes a Fraud Prevention Checklist. The Report can be found at https://www.acfe.com/report-to-the-nations/2020/.

Unit 5

Selected Additional Financial Statement Fraud Cases

LEARNING OBJECTIVE

After completing this section, participants will be able to:

- Recognize the most common financial statement fraud activities through selective case analysis

INTRODUCTION

The purpose of this section is to identify additional financial statement fraud cases to reinforce the three aspects of the Fraud Triangle: 1) motivation/pressure, 2) opportunity, and 3) rationalization. These cases provide powerful examples of the importance of organizations identifying fraud risk factors, implementing preventive and detective controls, and monitoring on an ongoing basis for changes in the environments the organization operates in. Note though, that in most of the cases in this section, management override was a consistent factor enabling the frauds to exist.

The fraud cases in this section are the following:

- Four Seasons Nursing Centers of America
- MiniScribe
- Informix Corporation
- Computer Associates
- Lernout & Hauspie Speech Products
- Baptist Foundation of Arizona
- Peregrine Systems, Inc.
- Mercury Finance Company

- Sunbeam Corporation
- Anicom, Inc.
- Parmalat
- Olympus Corporation

FOUR SEASONS NURSING CENTERS OF AMERICA

Four Seasons Nursing Homes of America was one of the first companies investing in senior living home and communities in the 1960s. Many small investors invested in Four Seasons expecting to see significant stock market gains as the industry grew. Unfortunately, a massive financial statement fraud took place and investors lost as much as $200 million. In order to increase the price of the shares to make the investment more attractive, Four Seasons Participated in the following two activities:

- Part of the company's earnings were based on sales of nursing homes with related gains that never took place.
- In addition, they sold poor producing properties to a related entity, recognizing inflated gains and not consolidating the related entity.

The price of the shares initially sold at $11, rose to $181, and then dropped to 6 cents a share once the Justice Department investigation was disclosed.

Motivation/Pressure – Continue to see share price increases to obtain more investors and increase executive's compensation

Opportunity – Fraud was perpetrated by three major shareholders of Four Seasons: 2 accounting firm partners, a Wall Street broker and underwriter, and the company's chairman – management override took place

Rationalization – Confident they will not get caught as long as they can continue obtaining new investors

MINISCRIBE

MiniScribe was a manufacturer of disk drives for computers. Initial customers included OBM, Compaq, Apple, and Digital Equipment Corporation. MiniScribe's CEO, Quentin Wiles, orchestrated a massive inventory fraud to overstate inventory balances, reducing cost of sales and increasing gross profit. In one instance, MiniScribe boxed bricks into disk-drive packaging and shipped these bricks to a warehouse as inventory. They also did not write off bad debts, backdated shipments, and repeatedly shipped defective disk drives to customers recording sales multiple times.

Motivation/Pressure – Increase operating income to maintain the stock price

Opportunity – CEO planned and supervised the inventory fraud

Rationalization – All parties benefit – stockholders, passive investors, and employees

INFORMIX CORPORATION

Informix was a software developer of relational database software. Informix was acquired by IBM in 2005. The SEC filing states that in November of 1997, the Company restated its financial statements for fiscal years 1994 through 1996 and the fiscal quarter ended March 30, 1997. During the period covered by the restatements, former employees of the Company, including salespersons, members of management (Philip White, CEO) and others engaged in a variety of fraudulent and other practices that inflated annual and quarterly revenues and earnings. These practices included:

- Backdating license sales agreements
- Entering into side agreements granting rights to refunds and other concessions to customers while still recognizing revenue from these transactions
- Recognizing revenue on transactions with reseller customers that were not creditworthy
- Recognizing amounts due under software maintenance agreements as software license revenues allowing for immediate recognition of revenue rather than spreading the maintenance revenue over the period of the maintenance agreement
- Recognizing revenue on disputed claims (contingent gains) against customers

These practices resulted in revenues being overstated by $312 million and net income overstated by $156 million.

Motivation/Pressure – Maintain leading market position in the technology industry after it fell behind competitors (Java) in technology development

Opportunity – Frauds were orchestrated primarily by the CEO to overstate revenue and earnings – management override took place

Rationalization – Maintain position as a market leader

COMPUTER ASSOCIATES

Computer Associates was ranked as one of the largest independent software corporations in the world. The company created systems software and applications software that runs in mainframe, distributed computing, virtual machine, cloud computing environments, mobile devices, and the Internet. In 2000, Sanjay Kumar replaced Charles Wang as Chief Executive Officer. In 2002, Kumar became Chairman of Computer Associates' board of directors. In 2006, he was sentenced to 12 years in prison and fined $8 million for his role in a massive accounting fraud at Computer Associates.

The SEC's complaint indicated that from 1998 to 2000, Computer Associates routinely kept its books open to record revenue from contracts executed after the quarter ended to meet Wall Street quarterly earnings estimates. In total, Computer Associates prematurely recognized $2.3 billion in revenue in FY 2000 and FY 2001 and more than $1.1 billion in premature revenue in prior quarters.

In addition to meeting Wall Street earnings estimates, the executive officers at Computer Associates, including Sanjay Kumar, had significant incentive compensation plan agreements and were also large shareholders. Any increase in earnings increased their compensation and drove the price of the stock higher.

Motivation/Pressure – Maintain the price of the shares and earn incentive compensation bonuses

Opportunity – CEO/Chairman orchestrated the fraud scheme – management override took place

Rationalization – Will never get caught

LERNOUT AND HAUSPIE SPEECH PRODUCTS

Lernout and Hauspie Speech Products was a Belgium-based maker of speech recognition, dictation, and translation software. Chipmakers such as Intel and NEC licensed their development tools to L&H which built devices that incorporated language and speech. Cofounders Jo Lernout and Pol Hauspie together owned 30% of L&H. Reported revenues of L&H grew from $100 million in 1997 to $344 million in 1999. L&H filed for bankruptcy in 2000.

On September 20, 2000, the SEC launched a formal investigation into the accounting practices at L&H. The SEC was seeking information about related party transactions and large increases in the company's sales in Korea and Singapore. Sales in 1999 to customers in Korea and Singapore were $143 million up from $300,000 the prior year.

During 1999 and 2000, Lernout and Hauspie set up 30 start-up companies in Singapore and Korea, funding their initial operations, and then charging research and development costs to these companies while recognizing license fees from these companies when they had no viable substance. None of the companies established had any revenue and many of the companies had the same officers and shareholders. Management, other that Lernout and Hauspie, were not aware of these transactions.

On November 9, 2000, L&H announced it was restating its financial statements for 1998, 1999, and the first half of 2000 to make up for past accounting errors and irregularities. On November 29, 2000, L&H filed for bankruptcy protection when it was discovered that, in addition to questions concerning sales in Korea and Singapore, $100 million was missing from the company's South Korea division – the money never existed.

Motivation/Pressure – Protect the investments made by Lernout and Hauspie

Opportunity – Lernout and Hauspie ran the company

Rationalization – Lernout and Hauspie personally benefited from the fraud

BAPTIST FOUNDATION OF ARIZONA

The Baptist Foundation of Arizona was created in 1948 to fund religious activities and projects sponsored by the Arizona Southern Baptist Convention. Baptist Foundation was a nonprofit agency initially focused on funding church activities and providing financial assistance to the disabled and children. Funding generally came from existing church members making contributions.

In 1984, new Foundation leadership took over that decided to develop another source of revenue – investing in real estate – to generate additional funding. In addition, the Foundation began selling promissory notes to individuals and churches throughout the country. The Foundation marketed these financial instruments as high-yielding retirement investments while, at the same time, improving the religious and social fabric of society.

In 1989, the Arizona real estate market collapsed, causing the Foundation to incur significant losses. The Foundation hid these losses by setting up off-balance sheet entities controlled by the officers of the Foundation, then selling these properties at inflated prices to these off-balance sheet entities for promissory notes and recognizing inflated gains. There was over 60 of these related party off-balance sheet entities established.

The Foundation was able to sustain itself through 1997 by selling more promissory notes using the new notes to pay interest on prior notes that were issued – a Ponzi scheme. The new Foundation leadership also diverted $140 million dollars to three directors using the off-balance sheet entities.

In August 1999, the Foundation was ordered to stop marketing its promissory notes and, as a result, it filed for bankruptcy the following November. The bankruptcy filing was the largest by a nonprofit entity in the history of the United States. 13,000 investors lost approximately $600 million dollars.

Motivation/Pressure – Greed

Opportunity – Poor oversight by the Arizona Southern Baptist Convention

Rationalization – This can go on forever as long as we can convince church members to continue giving us money

PEREGRINE SYSTEMS, INC.

Peregrine Systems, Inc. was an enterprise software company, founded in 1981, that sold enterprise asset management, change management, and service management software. Peregrine was acquired by Hewlett-Packard in 2005. The SEC stated in its complaint that this case involves a massive financial fraud. Peregrine filed materially incorrect financial statements with the SEC for 11 consecutive quarters between April 1, 1999 and December 31, 2001. Peregrine restated its financial results for the fiscal years 2000 and 2001 and for the first three-quarters of fiscal year 2002. Peregrine reduced previously reported revenue of $1.34 billion by $509 million, of which at least $259 million was reversed because the underlying transactions lacked substance. The fraudulent financial statement practices included:

- Recording hundreds of millions of dollars of revenue despite nonbinding arrangements with customers – earnings process not complete.

- Material sale contingencies were secretly added by side agreements.
- Peregrine routinely kept its books open after fiscal quarters ended, and improperly recorded as revenue, for the prior quarter, software transactions that were not consummated until after quarter end.
- Peregrine borrowed monies on fictitious receivables from transactions described above and accounted for these borrowings as sales of the receivables and removed them from Peregrine's balance sheet.
- Senior employees concealed the revenue frauds and resulting collection problems by improperly writing off receivables.

Motivation/Pressure – Inflate Peregrine's revenue and stock price – to meet or exceed quarterly revenue forecasts

Opportunity – Peregrine officers and sales personnel directed these financial statement fraud schemes – management override took place

Rationalization – We will not get caught

MERCURY FINANCE COMPANY

Mercury Finance Company was a subprime lender whose corporate officers intentionally misstated the company's financial records. Mercury executives falsely reported a 1996 profit of more than $120 million instead of a loss of $30 million. Executives provided materially false financial statements to more than 20 financial institutions, enabling Mercury to obtain more than $1.5 billion in loan commitments and lines of credit. Corporate officers had a significant number of stock options and to maintain their value, they committed financial statement fraud. Actions taken by these corporate officers included:

- Made a journal entry to add $31,850,000 to accounts receivable and revenue. This amount was fraudulent.
- Reduced short-term debt by $30,000,000 to offset the overstated accounts receivable when challenged by their auditors. The debt was still owed to a bank.
- At a later date, Mercury reversed the $30,000,000 entry and put the fraudulent receivables back on the books.

When the fraud was discovered, Mercury's stock price dropped significantly, costing shareholders nearly $2 billion in market value. In addition, lenders lost over $40 million in loans extended to the company. Lawrence Borowiak, former Accounting Manager, was sentenced to 12 months in prison and ordered to pay $585,000 in restitution after pleading guilty to insider trading charges. Former Treasurer Bradley Vallem pled guilty to wire and bank fraud and was sentenced to 20 months in prison. In October 2006, former Chief Executive Officer John Brincat, Sr. pled guilty to wire fraud and making a false statement to a bank. On May 23, 2007, Brincat was sentenced to 10 years imprisonment.

Motivation/Pressure – Greed; maintain the price of the shares

Opportunity – Corporate officers committed the fraud – management override took place

Rationalization – We are too smart to get caught

SUNBEAM CORPORATION

Sunbeam Corporation was a consumer products business with 12,000 employees and over 12,000 different product lines. Its business was declining, stock price decreasing, and management was not able to stop the bleeding. Management hired Al Dunlap (Chainsaw Al) as the CEO and chairman of the board for Sunbeam Corporation in July 1996. Dunlap was a turnaround specialist and the hope was that he could turnaround Sunbeam.

Under Al Dunlap's leadership, Sunbeam's stock price increased from $12 to $52 within two years. The problems though continued and Sunbeam's business continued to decline. According to the SEC's complaint, Dunlap engaged in a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam and thus facilitate the sale of the Company at an inflated price. Fraudulent financial statement activities included:

- Creating unneeded reserves in 1996 (cookie jar), increasing 1996's losses. These reserves were used to overstate 1997's net income making it appear that the turnover was starting to be successful
- Created $60 million of fraudulent revenue in 1997 to give the appearance that the turnaround was taking place
- Participated in channel stuffing activities in 1997 to accelerate revenue in 1997 at the expense of revenue in later years – offered discounts to customers to buy more product
- Overstated revenue and earnings that did not exist in 1998 in anticipation of a bond offering

Motivation/Pressure – Dunlap wanting to maintain his reputation as a turnaround specialist

Opportunity – Dunlap ran the company and orchestrated the frauds

Rationalization – Sunbeam appears to be doing well; Dunlap does well

ANICOM INC.

Anicom was a national distributor of wire and cable products with 1,200 employees before going bankrupt after six executives were indicted for participating in a corporate financial statement fraud scheme. The financial statement fraud scheme continued for three years. Financial statement fraud activities included:

- Overstated sales and net income by creating numerous fictitious sales and fraudulent billings
- Overstated sales and net income by creating $10 million of sales to a fictitious company
- Recorded fraudulent journal entries to overstate revenue and understate expenses

- Recognized sales for products that had not yet been shipped and sales for products that had not been ordered by customers

- Reduced uncollectable receivables that resulted from fraudulent sales and billings by crediting the uncollectable receivables and issuing another fraudulent sale to a fictitious customer

Motivation/Pressure – To continue to receive Incentive compensation bonuses

Opportunity – Executives of the Company – management override took place

Rationalization – We will never get caught

PARMALAT

Parmalat is one of the largest dairy and food companies in Italy. In began as a family owned farm in the early 1960s. Parmalat entered into an acquisition strategy in the late 1990s that resulted in unexpected operating losses. As a result of these losses, Parmalat's entered into a financial statement fraud that lasted over 10 years primarily designed to hide these losses and maintain the price of the shares. A significant part of the fraudulent activity involved using related parties and numerous special purpose entities to hide the true nature of transactions. The following are selected financial statement fraud activities performed by Parmalat:

- Parmalat's reported long-term debt as of September 30, 2003 was $2.3 billion – by itself a significant amount for a low-risk food and dairy business. A fraud audit though undertaken by the board at this time indicated that long-term debt was over $18 billion. The two most used fraudulent activities to hide this debt were to report proceeds from borrowings as sales and to misrepresent borrowings from related parties as equity transactions.

- Parmalat had hundreds of subsidiaries and hundreds of off-balance sheet special purpose entities. Parmalat used these entities to misrepresent borrowings as sales, to overstate their consolidated cash position, and to distribute cash to related parties without recording the cash disbursements.

- Parmalat would double bill existing customers and then use the fraudulent invoices to gain additional credit from Italian banks.

One significant red flag that should have been obvious during this period was the significant amount of cash that was reported to be on hand while Parmalat was constantly going into the market to borrow more money.

Motivation/Pressure – Recurring losses due to mismanagement of the business

Opportunity – Dominant CEO and related family members, the board was not independent, and related party transactions were frequent

Rationalization – Culture resembled that of a family business where the company was a big cookie jar to benefit the family

OLYMPUS CORPORATION

Olympus is a Japanese manufacturer of optical imaging and medical equipment. For a 20-year period ending in 2008, Olympus incurred investment losses of $2 billion that were not reported in its financial statements. Olympus participated in a Tobashi Scheme, which is a financial fraud that hides losses in an off-balance sheet investment entity (shell company) by selling, allegedly, the investments at inflated values to conceal the actual losses.

The New York Times reported on December 8, 2011 that "the plan was to get out of the losses eventually, either by more investments or through overpriced acquisitions, with the extra cost of the acquisitions going to the off-balance sheet subsidiaries to make them whole. That was done through a variety of means, one of which was retaining the phony companies as high-priced investment advisors. That cost would be put on the company's balance sheet as goodwill, and eventually written off. When this was done, the balance sheet would show the accurate value of Olympus." In other words, the goodwill impairments would replace the investment losses.

Motivation/Pressure – Japanese culture which values peace and harmony, does not consider it wrong to lie if the truth will cause embarrassment to others. Rather than admit the investment losses and have to blame some employees for these losses, they were hidden for 20 years.

Opportunity – The CEO and Chairman of the Board, along with the board and the outside accounting firm were all complicit in the cover up.

Rationalization – Peace and harmony are preferred outcomes over truthfulness if truth will cause disharmony and embarrassment.

NOTES

NOTES

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