Corporate financial statement fraud

ICFP development session
5 August 2015
Agenda

• Factors that contribute to financial statement fraud
• Fraudulent financial statement schemes
• Synopsis of the Olympus fraud scandal

This presentation is based on information or references obtained in different textbooks and articles referred to in the resources section of the presentation
Factors contributing to financial statement fraud
Factors that contribute to financial statement fraud

- Booming economy
- Decay of moral values
- Misplaced incentives
- High analyst expectations
- High debt levels
- Focus on accounting rules rather than principles
- Lack of Auditor independence
- GREED
- Educator failures
Factors that contribute to financial statement fraud

- **Booming economy**
  - 1990's – Dot.com bubble
  - Early to mid 2000's – 2008 Financial crisis
    - These booming economies allowed fraudsters to conceal their actions
    - Executives believed that their companies were more successful than they actually were
      - Can't determine the reason behind their success, but management claims it
      - When circumstances change (such as economic factors) management incorrectly think that past methods will continue to be successful
      - When it fails, management is under increased pressure which contributes to fraudulent financial reporting

- **Decay of moral values**
  - Whatever form of integrity one uses – Dishonesty seems to be increasing
    - Researchers found that cheating in school has increased substantially, for example - Copy work, using a cheat sheet or lying to obtain a job
Factors that contribute to financial statement fraud

• Misplaced incentives
  – Executives received hundreds of millions in stock options that placed tremendous pressure on management to keep stock prices rising at the expense of accurate financial reporting
    • Bernie Ebbers - 1997
      – Salary $935,000
      – Stock options, corporate loans - $409 million
    – Incentives caused the attention of management to shift from managing the firm to managing the stock price

• High analyst expectations
  – Unachievable expectations of analyst that targeted short term behaviour
  – Boards generally used other similar firms' share and achievement of analyst expectations
  – Stock based incentives compounded the pressure induced by analyst expectations
Factors that contribute to financial statement fraud

• High debt levels
  – High debt levels place pressure on earnings in order to
    • Offset interest costs
    • Maintain credit rating
    • Meet debt covenants
  – Enron had 54 pages in its financials to disclose all its debt
  – Worldcom had $100 billion in debt when it filed for bankruptcy

• Focus on accounting rules rather than principles
  – US accounting rules were "rules based" and not "principle based" as in countries like UK or Australia
  – Allowed companies to find loopholes in the accounting rules or to account for transactions that violated the principle of the accounting method but it was within the rules
    • Lack of specific rules were exploited through complicated financial arrangements
Factors that contribute to financial statement fraud

- **Focus on accounting rules rather than principles (con't)**
  - For example
    - "Even if Arthur Anderson argued that Enron's special purposes entities were inappropriate, it would have been difficult to demonstrate that Enron violated any specific rules"
    - Some suggest it was a reason the Enron case took so long because it was not immediately clear which accounting rules or laws were broken"

- **Lack of auditor independence**
  - Audit firms used audit clients as "loss leaders" in order to secure consulting work from audit clients
    - Audit fee was minimal compared to consulting fee
    - Some auditors lost their focus and became business advisors and not auditors
  - New independence rules make it increasingly difficult to do consulting work for audit clients
Factors that contribute to financial statement fraud

• GREED
  – Executives, investment banks, commercial banks and investors
    • Everyone benefited from a strong economy, lucrative transactions and high profits
  – None of them wanted BAD NEWS!

• Educator failures
  – Lack of ethics training
    • In one fraudulent scheme more than 20 individuals were involved which points to an ethical failure
  – Lack of fraud awareness
  – Accounting training
    • Focus less on teaching content rather use content as a context for helping student to develop analytical skills
    • Many cases where accountants applied what they thought were appropriate content to unstructured situations, only to find that they missed the major risks inherent in the circumstances
Fraudulent financial statement schemes
Discussion points

• What are the general principles when manipulating financial results?
• Types of fraudulent financial schemes
  – Concealed liabilities and expenses
  – Fictitious revenues
  – Improper asset valuations
  – Improper disclosures
  – Timing differences
• Financial statement fraud vs misreporting – When does it become fraud?
General principles during financial statement manipulation

- Overstatement of **assets and revenue**
- Understatement of **expenses and liabilities**
- Understand financial **KPIs** that drive management incentives
  - Stock options
  - Bonus KPIs
  - Other KPIs that drive management behaviour
General principles during financial statement manipulation

- Fraudulent entries are many times **credit entries**
  - Income statement – Increase revenue or decrease expenses
  - Balance sheet – Cash or assets misappropriated is a credit entry

- **The trick is to find a suitable account for the debit entry that will conceal the fraud!!!**
  - Suspense accounts, intercompany accounts, VAT control accounts etc
  - High volume accounts with a balance that is difficult to determine
Concealed liabilities and expenses

- Why are liabilities and expenses concealed?
  - To make a company look more profitable because pre-tax income will be increased by the full amount of the liability or expense not recorded

- What are the common methods of concealing liabilities and expenses:
  - Liability/expense omission
  - Capitalised expenses
Concealed liabilities and expenses

- **Liability/expense omission**
  - Enron
    - Hid debt in off-balance sheet SPVs
  - Simplest method is not to record them
    - Potential adverse judgments through litigation or breach of contract
    - Not recording vendor invoices at year-end
  - Probably one of the hardest types of financial misstatement to detect because it is so easy to conceal

- **Capitalised expenses**
  - Worldcom
    - Capitalised line rental cost, IT cost and operational expenditure
  - Capital expenditure provides a benefit to company over more than one year
    - Other expenditure correspond to revenue generation and should be expensed in a particular accounting period
Concealed liabilities and expenses

- **Capitalised expenses**
  - Major capital projects
    - Energy projects
    - Infrastructure projects
    - New IT system roll outs
    - Mining industry
      - Mine shafts and expansion under ground
  - Dumping operational cost against capital projects
    - Repairs & maintenance, excess payroll expenses, non project related dumped against capital projects
    - Compensation events on major capital projects
  - Understand the nature of the project to determine if expense relates to the project and whether it should be capitalised
Fictitious revenue and timing differences

- Fictitious sales modus operandi
  - Fictitious sales to phantom customers
    - Satyam ("Indian Enron")
      - Inflated sales to technology company
      - Concealed it by procuring offices and hiring employees to make revenue seem possible for analysts
    - Sales invoices generated but not sent to customer
      - Debtors circulation will normally detect mismatch in balances
      - Company balance vs customer balance
  - Inflated sales to existing customers
    - Channel stuffing over reporting periods
      - Sales agent wants to achieve targets for commission
      - Customer does not order in next financial period due to excess stock on hand or returns stock
      - High volume industries affected for example – cigarettes, pharmaceuticals, perfume etc
Fictitious revenue and timing differences

• Recognition of fee/income on transactions
  – Premature recognition of revenue
    • Enron mark to market accounting on long term future contracts
    • Sales subject conditions in contract
      – Revenue only to be accounted as conditions are met but revenue is acknowledged irrespective of conditions
  – Example - Sales recognised based on quotation provided to customers
    • Service delivery company
    • 2nd year after listing revenue was under pressure
    • Accounting team started recognising revenue based on quotations/proposals provided to customers
      – Credited revenue and debited WIP (not debtors)
      – At year end WIP balance was half of Turnover

• Understand how revenue is generated for different companies – this will highlight different risk areas of manipulation
Improper disclosures

- Improper disclosures generally consist of
  - Liability omissions
  - Subsequent events
  - Management fraud
  - Related party transactions
  - Accounting changes

- Relevant case study – Olympus
  - Will be discussed later
Improper disclosures

• Liability omissions
  – Loans covenants
  – Contingent liabilities

• Failure to disclose subsequent events
  – Regulatory investigations and penalties
  – Major events after year-end that affect the financial results

• Withholding information about management fraud

• Non-disclosure of related party transactions
  – Specifically related party transactions that are not at arms length
    • Major contract with the company
    • TYCO - Staff loans and Executive loans not approved by the Board

• Accounting changes
  – Changes in significant estimates
    • Life of mine calculation & rehabilitation provision
    • Post retirement medical aid liability
Understand management incentives

• **Stock options**
  – Extent of allocation to management
  – Strike price vs current market price
  – Economic factors or major transactions that will impact the share price
  – Back dating of stock options

• **Bonus KPIs**
  – Which line items are affected by KPIs
    • Revenue targets – Turnover, net profit, return on capital invested
    • Reduction in costs – Cost to income ratio, major expense items that needs to be reduced (payroll cost or other operating costs)

• **Other management KPIs**
  – Spending full capital budget allocated
  – Items in sustainability report
  – Safety
  – Earn-out clauses
When does a financial error become financial statement manipulation?
When does a financial error become financial statement manipulation?

- It has to do with **intent**. A bona fide error is normally free from fraudulent intent.
- However, intent needs to be **proven** through evidence which must demonstrate that
  - **Perpetrator committed an act** – Fraudulent transaction/s authorised or performed by the perpetrator
  - **The concealment of the act** – Key to proving the action was fraudulent. Evidence how the perpetrator was involved or a confession from the accused or co-accused
  - **Benefited from the act** – Directly via cash received or indirectly through other management incentives
Synopsis of the Olympus fraud scandal
Origins of the financial loss at Olympus

• "The dollar had been rising at a good clip and by the end of 1984 was worth more than 250 yen. That was heavenly for Japanese exporters, who could reap large profits exporting to the United States, and it led to a gaping Japanese trade surplus with the United States.

• The Plaza Accord was reached by what was then the Group of Five — Japan, the United States, West Germany, France and Britain — at the Plaza Hotel in New York. They agreed on concerted action to bring down the value of the dollar, and to the surprise of many it worked.

• By the end of the year, the rate was down to 200 yen, and by the end of 1987 it was only 121 yen.

• It was no longer as much fun to be a Japanese exporter. "

Origins of the financial loss at Olympus

• "But the Japanese bubble was still expanding. In the final four years of the decade, stock prices tripled. In 1985, Olympus — not alone among Japanese companies — introduced zaiteku, or speculative investment, as a major business strategy.

• The strategy worked until the Japanese bubble burst in 1990.

• That year, the company chose to hide losses of nearly 100 billion yen, or about $730 million at the exchange rate at the time. The report does not detail exactly how those losses came, only saying that they involved financial instruments.

• How could such a loss be hidden? At the time, accounting rules in Japan, as well as in other countries, allowed investments to be carried at cost. Theoretically, there should eventually have been a write-down, but there never was. "

Corporate financial statement fraud
Changes in accounting rules

Valuation of investments

- "Olympus seems to have been content to sit on the losses until 1997, when accounting rules changed and some investments had to be marked to market. To do so would reveal the entire sordid tale."

Consolidation of shell companies

- "Enron case in 2001 revealed how shell companies it controlled were moved to liabilities on off balance sheet"
- "Accounting rules changed slowly but by 2007 Japanese accounting rules were changed, stating that shell companies had to be consolidated"
Synopsis of the corporate scandal

• Tobashi – "…to sent something flying away…"

• So a plan was developed to “sell” the losing investments, at original cost, to shell companies set up by Olympus for that purpose.
  • Loss separation scheme

• Subsequently sold to new subsidiaries when accounting rules surrounding consolidation of shell companies changed and loans had to be repaid
  • ITX
  • Altis, Humalabo & News Chef
  • Gyrus Group

• More than US$ 1.5 billion in investment losses were hidden over a decade
Phase 1 – Loss separation scheme

- Olympus
- CD deposits
- Payment with loans received from bank
- Sale of loss making investments
- Banks
  - Commerzbank
  - LGT
  - Société Générale
- Loans (Collateral CD deposit)
- Cayman Island funds set up by Olympus
Journal entries – Phase 1 – Loss separation scheme

- **Olympus**
  - **1st entry**
    - Dt CD deposit
    - Ct Bank
  - **2nd entry**
    - Dt – Cash received from unrelated entity (loan from Bank)
    - Ct – Sale of investment (loss making investments)

- **Shell company – Unconsolidated**
  - **1st entry**
    - Dt Bank
    - Ct Loan from bank (Backed by CD deposit from Olympus)
  - **2nd entry**
    - Dt Investment acquired from Olympus (loss making investments)
    - Ct Bank (payment to Olympus)
Phase 2 – New business development

Olympus

Cash investment from Olympus

Share to Olympus

New Olympus subsidiaries
- ITX
- Altis
- Gyrus Group

Purchase of investments

Repayment of CD deposits

Banks
- Commerzbank
- LGT
- Société Générale

Repayment of loans

Cayman Island funds set up by Olympus

Sales of worthless investments
Journal entries – Phase 2 – New business development

- **Olympus**
  
  1\(^{st}\) entry
  - Dt Investment in new subsidiary
  - Dt Goodwill (huge overpayment of the value of the new subsidiary)
  - Ct Bank

  2\(^{nd}\) entry
  - Dt – Cash (redemption of CD deposit)
  - Ct – CD deposit

- **Shell company** - (unconsolidated entity)
  
  1\(^{st}\) entry
  - Dt Bank
  - Ct Sales of investments (new Olympus subsidiary)

  2\(^{nd}\) entry
  - Dt Loan payable to bank
  - Ct Bank
Journal entries – Phase 2 New business development

- New Olympus subsidiaries
  
  1st entry
  - Dt Bank (cash received from Olympus)
  - Ct Stock issued to Olympus

  2nd entry
  - Dt – Investment acquired (old worthless investments)
  - Ct – Bank (proceeds paid for worthless investments from cash received from Olympus)
What happened as a result?

- Old investment losses were turned into **GOODWILL**

- **Goodwill** could be written down by Olympus as and when required
  - "Because new start up companies did not work"
Michael Woodford – 2011 timeline

- Was at Olympus for more than 30 years
- 1 April 2011 appointed as COO and President
- 1 July 2011 – Allegations of corporate irregularities surfaced in *Facta*, a Japanese magazine and German colleagues informed him
  - Could not find satisfactory answers
  - Employees were instructed not to discuss allegations with him
  - Woodford wrote letters to the Board seeking answers
- 1 October 2011 – Appointed as CEO
  - Appoints PWC to investigate allegations
- 14 October 2011 – Dismissed as CEO and Woodford discloses his concern publicly
- 8 November 2011 – Olympus admits to scandal
- 21 December 2011 – Olympus raided by law enforcement
Aftermath

- Market capitalisation plummeted?
  - Fell 63% in **ONE DAY** after Woodford was dismissed 14 October 2011

- What happened after the scandal was uncovered?
  - Woodford – Received price "Business person of the year for bravery and whistleblowing"
  - Woodford received £10 million for damages from Olympus for defamation and wrongful dismissal
  - Kikukawa & Mori received 3 year prison sentences (5 years suspended)
  - Yamada went to prison for 2.5 years (4 years suspended)
  - Olympus received $7 million fine
  - Olympus will retrench 2 700 workers and close 40% of production plants by 2015
  - Other banks (not involved in scandal) claim $273 million from Olympus in damages
Resources

- Forensic Accounting – Zimbelman & Albrecht
- Forensic accounting and Fraud examination – Kranacher, Riley Jr and Wells
- How to hide a multibillion dollar loss? Accounting for the Olympus fraud – Francine Mckenna
- Deep roots of fraud at Olympus – Floyd Norris New York Times
- Olympus scandal - Wikipedia
- Investigation report summary - 6 December 2011
THANK YOU