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FRAUD IN THE FINANCIAL STATEMENTS IS AN ELUSIVE THING

By Lesley D. Hand, CPA, CFE, CFF

INTRODUCTION

Fraudulent financial reporting is the deliberate reporting or omission of financial information in an effort to avoid negative opinions or to present things in a more positive view than the reality of the situation. It is a conscious effort to mislead; it is not something being overlooked by accident. It is not unusual for supporting documents to be altered in an effort to support the false and misleading impression.

The Commission of Sponsoring Organizations of the Treadway Commission reported that there were 347 alleged cases of public company fraudulent financial reporting from 1998 to 2007.

THE MOTIVES AND METHODS OF FRAUD

Fraudulent financial reporting is done for many reasons but often is associated with:

- A desire by management to report smooth, regular—and an often increasing pattern of—earnings. This may occur top level at corporate or at a division or segment level where decentralized accounting with opportunities, incentives, and/or pressures exist.
- A desire to provide investors, bankers, and Wall Street with the results they expect.
    - Any shortfall from consensus earnings and/or sales growth is often associated with a drop in share price,
    - Violating debt covenants (such as debt levels, EBITA levels, etc.) can create downward pressure on stock valuations and classification and/or repayment issues and/or crossover collateral provisions in other debt and/or long term agreements may be triggered (classification and repayment). In addition, it goes without saying that related but higher borrowing costs (which often follow) can create pressures on earnings potential, and
    - Investors may pressure boards to review upper management and boards may begin to have expectations about changing management.

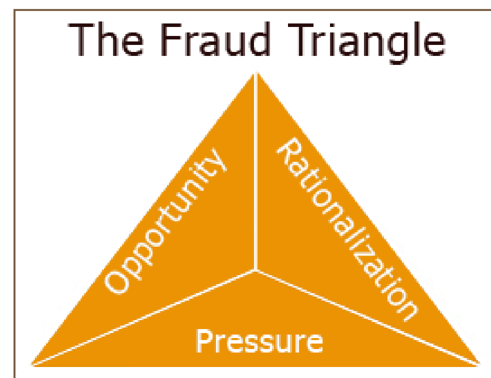
Accounting literature provides that improper accounting and/or disclosures can result from errors (i.e. unintentional misrepresentations of GAAP) or irregularities (i.e. intentional misreporting).

Fraudulent financial reporting may be accomplished by any of the following individually or in combination.

- Making false or misleading statements,
- Misrepresentation and/or intentional omission of key factors or information about events, transactions, restrictions, and/or side deals or agreements,
- Falsification and/or alteration of accounting records including contracts and/or agreements in order to mask or hide facts that would render the accounting false, misleading, and/or inappropriate, and
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, and/or disclosures.

THE FRAUD TRIANGLE

Most frauds include one or more factors that constitute what most accountants refer to as the "fraud triangle." These factors are 1) incentives and pressure, 2) opportunities and attitude, and 3) rationalization.



1) Incentives and Pressure are the things that come to mind quickly. Clearly bonuses, stock options, compensation, and promotions provide logical incentives. Likewise the pressure to achieve expected results or the pressure associated with real or perceived threats of being fired, demoted, or passed over for promotion can cause the bad behavior. In addition, people sometimes generate the pressure due to the desire to receive special recognition.

In one case of fraudulent financial reporting, the controller manipulated a subsidiary's numbers because he had done the due diligence and recommended the acquisitions. Then when the subsequent financial results were disappointing, he manipulated the numbers. He stated that he felt bad because he did not want to disappoint management and he thought things would get better but they did not. His written admission was drafted on April Fool's Day and the CEO was hoping it was a joke. Sadly for the company and the controller, it was a truthful admission.

Even honest individuals can succumb to committing fraud under enough pressure. The greater the pressure, the more likely an individual will rationalize committing fraud. Bad economic times, limited savings, poor job prospects, financial issues can cause an individual to rationalize bad behavior.

In some cases, the financial incentives are so large that an individual's moral compass is deactivated.

2) Opportunities often present themselves when financial controls are ineffective or can be overridden. They exist when an individual has the ability to distort reality by false, deceptive, or papered documents inconsistent with the true economics of the transaction.

The American Institute of CPA's publication, "Management Override of Internal Controls - The Achilles' Heel of Fraud Prevention," notes that, "Many financial statement frauds have been perpetrated

by intentional override by senior management of what might otherwise appear to be effective internal controls."

3) Attitudes/Rationalizations Given enough pressure, many individuals will rationalize that their behavior to justify cooking the books. Often used rationalizations include but are not limited to: "everybody does it," "nobody will notice," "I'm doing it for the good of the company," "it is just a timing thing," or "we have always done it this way". Once rationalization occurs, the perpetrator becomes invested in the answer and almost becomes indignant in the defense of the bad behavior if caught. Some well-known frauds have covered many years and dozens of participants.

A typical pattern of fraud often:

- Does not start with dishonesty.
- Begins with pressure.
- Often happens in subjective areas.
- Often starts small. It may even be a mistake that is not detected but gives a result that reduces pressure and/or increases incentives.
- An opportunity is always present.
- It is rationalized.
- It grows over time.
- Eventually there is no way out.

Fraud in the financial statements can appear anywhere. It can reside on the balance sheet, in the income statement, the statement of cash flows, and/or disclosures. It normally affects both the balance sheet and income or cash flow statements. It can affect disclosures.

Highly subjective areas are potential areas for fraud. This is especially true if the areas involve the use of significant estimates where judgments or uncertainties are difficult to corroborate. Right of return reserves, allowance for doubtful accounts, warranty reserves, inventory reserves, loss contingencies, and miscellaneous accruals are examples of high risk areas.

As previously stated, accounting entries often are manipulated to show a smooth, regular, and increasingly trend to earnings. This has often been accomplished by tucking away earnings above analyst expectation in a "Rainy Day Fund". The funding of a rainy day account is often done by reducing revenue or increasing expenses with a corresponding increase in a liability account. The entry or entries needed to fund the rainy day accounts may be spread over a number of accounts to reduce the risk of detection. If detected, it will first likely be argued as immaterial or explained as necessary for some previously unforeseen liability or contingency. These entries are used to manage earnings to meet analyst expectations.

Once a rainy day fund is established, it can be used in a future period. The fund can be reduced or increased in an account to meet analyst expectations.

SOME EXAMPLES

Some examples of fraudulent transactions that have been used by companies include:

- The automatic accrual of repairs and maintenance to individual store profit and loss statements to build up a "rainy day fund".
- The recording of non-recurring receipts to an accrual account (referred to in one investigation as a "Spoils Account"). Items included in the spoils account included rebates on utility bills, cancelled country club memberships, executive auto sales and proceeds from cancelled life insurance policies on executives.
- In one case, a fraudster took a loan made to a developer that had gone bad and reclassified the loan to a property account. He then depreciated the fictitious assets. The email that led to this discovery joked that the maker of this journal entry would be retired before the loan now treated as a building was fully depreciated. This was done to hide the loss that should have been recorded when the loan was judged worthless. The effect of this fraud was to take an otherwise immediate write off and spread it over the 30 year estimated life of the non-existent building.
- The recording of revenue without any real billing to a customer.
- Gross margins and profits can be created by shifting items between gross profit spoils when the retail method is used to value ending inventory. For example, if you take an item that has a 20% gross profit and re-classify the item to 50% gross profit pool you will increase your margin in the income statement by 30%.
- Another way to inflate sales is through the use of side letters. The base sales agreement is a standard vanilla contract. You agree to buy and I agree to sell for X dollars, which is payable within 30 days of receipt and acceptance. The seller records a sale. If, however, there is a side letter that says you can return this product to the seller for any reason, then revenue recognition is generally deferred. Financial Accounting Standard No. 48, "Revenue Recognition When Right of Return Exists," includes, as a criterion for recognizing revenue when the rights of the return exist, that "the amount of future returns can be reasonably estimated."

Fraudulent financial accounting is usually investigated under the direction of the audit committee. The audit committee will normally hire an independent law firm with experience in performing investigations and the law firm will usually hire forensic accountants to assist in the investigation.

Most investigations will include the capture and searching of electronic data. The first data searches are usually focused on people likely to influence or perform the actual recording of the improper accounting. The general rule is to include people one level above and below the key people of interest. The message here is "To Be Careful of What You Say", and do not write it down unless you would be comfortable reading it on the front page of the newspaper. Some examples of employee emails recovered by forensic accountants follow:

- "Separate the contract into two pieces so I can get the accounting needed."
- "Clear excess accrual to the 'Rainy Day Fund'."
- "Can you justify using this excess accrual somewhere else?"

- "Don't pay until they pay us." (Concurrent transaction)
- "I need two cents to meet consensus earnings."
- "Can you work some magic to increase reserves?"
- "Call vendors and get some additional promotional funds."
- "Shift items in retail inventory pool to increase gross margin."
- "Help fix [Dollar General] OMRON book value issue...book loss."
- "Hide field before giving to auditors."
- "Don't show auditors."

CASE STUDY: DOLLAR GENERAL AND IBM

All of this is interesting, but let's examine the specific case of Dollar General ("DG") and IBM as documented in various public documents, including SEC filings. DG is a Tennessee-based retailer, operating over 7,000 stores in 30 states. It purchased retail sales equipment (electronic cash registers) from IBM. The story of this fraud is found, among other places, in:

- Complaint-Commission vs. Dollar General, et al. (4/7/2005)
- Litigation Release No. 19174 - Commission vs. Dollar General et al. (4/7/2005)
- Litigation Release No. 19653 - CFO Burr (4/12/2006)
- Order Instituting Cease-and-desist... Release No. 55954 - IBM
- Complaint-Commission vs. Kevin B. Collins (6/25/2007)
- Litigation Release No. 20166 - SEC vs. Kevin B. Collins (6/25/2007)

All settlements state that —"without admitting or denying the findings..." The various complaint and litigation releases include the following allegations:

- Between 1998 and 2001 engaged in fraudulent improper accounting practices,
- The restatement reduced DG's pre-tax income by $143 million, or about $0.30 cents per share, and
- DG's misconduct included:
    - Under reporting at least $10 million in import freight.
    - Engaging in an $11 million sham sale of outdated, essentially worthless cash registers.
    - Overstating cash balance.
    - Manipulating reported earnings through use of a "Rainy Day Account".
    - Failure to maintain accurate books, records, and filings.
    - Failure to maintain adequate internal accounting controls.

Some of these are detailed below.

FREIGHT EXPENSE

In 1999, the company discovered it had failed to record $13.4 million of freight expense in 1999 and prior years. Executives decided not to restate and to recognize approximately $10.0 million monthly in fiscal 2000. This was done because DG had already disclosed to the public the earnings for 1999 and because it would negatively impact 1999 bonus targets. This fact was known to CEO, CFO, Controller and Chief Administrative Officer.

Subsequent to its discovery the treasurer expressed his concern that management could be compromising its ethics. This information was communicated to the CFO by the treasurer and general counsel. No one told the outside auditors.

Ultimately, $4 million was written in 1999 and $9.4 million was recognized monthly in fiscal 2000. In an attempt to hide the $9.4 million, $1.3 was parked in the "rainy day fund" and $2.7 was moved to corporate bank account. This deferral of costs allowed the company to meet analyst expectations and the company was able to meet established targets for employee bonuses.

SHAM SALE

IBM tried to get DG to accelerate its planned multi-year roll out of electronic cash registers by offering $1.0 million discount. DG determined that it would not take the deal because it would require a write off of the book value of the older registers. DG turned down the deal 11/29/2000.

IBM made an 11/30/2000 counter proposal addressing DG's "accounting concerns". If DG would take all cash registers now, then IBM would buy old cash registers and add the purchase price paid for the old cash registers to the new cash registers.

IBM and DG entered into two separate agreements to memorialize the purchase and sale agreements.

DG used $5.5 of the $11.2 million sales proceeds to fraudulently reduce expenses. This sham transaction also removed undepreciated assets and allowed DG to not restate the first 3 quarters of 2000.

RAINY DAY FUND

This miscellaneous accrued liability account was used in some instances to manage earnings. Emails suggested that if DG earnings reached an earnings level, that DG should report less and put $2.5 million in reserve.

CASH OVERSTATEMENT AND COVERINGS

DG failed to properly or timely reconcile its consolidated retail store bank accounts. Management was aware and the outside auditors communicated this to the audit committee.

Once DG completed the reconciliation in 2000 (at least 2 years after the issue was raised), they discovered an unexplained overstatement of cash of at least $4.7 million. The controller wrote off $3.8 million to the franchise purchase discount account and placed $1.9 million in the "Rainy Day Fund".

DG FAILS TO ACT ON DISHONESTY CHARGES AGAINST THE CONTROLLER

H.R. received a letter from the assistant controller that among other things raised concerns over the cash accounting and non-disclosure of the cash overstatement to the CFO. This letter was discussed with

senior executives and the audit committee chair, who concurred that the controller should be fired. The CEO ignored these recommendations. No one told the outside auditor.

OTHER ISSUES

DG failed to use full accrual accounting. They used cash basis accounting for many recurring expenses such as property taxes, common area charges, general freight, supplies, and utilities. The resettlement disclosed that failure to follow full accrual accounting overstated DG's pre-tax income by $2.0 million in 1998, $3.9 million in 1999, and $4.6 million in 2000. When a company is growing and expanding by adding new stores it increases the difference between cash basis and full accrual. Both methods have 12 months of cost but the accrual method reflects the costs in the proper 12 month period.

DG also received special vendor allowances for new store openings. There is no problem with these allowances but the method and timing of recording these allowances were not in compliance with generally accepted accounting. Accordingly, the accounting by DG was improper. Prior to 1999 DG would recognize the special allowances one month before store opening and in 2000 they recognized these special allowances three months early. This improperly recognized the allowances prior to store openings and the subsequent sale of merchandise.

Other areas of improper accounting included the improper treatment of synthetic leased facilities, mishandling of expenses changed to tax reserves, aged inventory markdowns, a change to discount methodology for calculating workers compensation reserves, inventory gains, and mishandling of receivables for bad checks.

INSIDER TRADING

The CFO, after being terminated, insisted on 4/12/2001 that accounting issues needed to be addressed and he wanted a release from DG from any responsibility for certain accounting issues. On 4/5/2001 and 4/27/2005 he sold stock at prices from $22.50 to $24.02.

After the company's press release on 4/30/2001 about the restatement, the stock dropped to $15.71.The press release included a dollar amount estimate for the impact of the restatement. The CEO had insisted they include the estimated effect of $0.07. The company did qualify its estimate. This dollar estimate was against the recommendations of the CFO and DG's outside accountants. The actual restatement on 1/14/2002 reduced earnings by $0.30 cents per share.

IBM'S ROLE IN THE SHAM TRANSACTION

IBM assisted DG in the fraudulent reporting of a sham transaction. IBM's papering a contract to purchase worthless cash registers was a sham. This transaction was in essence just a loan. The new equipment price being purchased by DG was increased by exactly the amount paid for the worthless cash registers disguised "purchased" by IBM. The amount paid by IBM for the old obsolete and worthless cash registers actually exceeded the cost of the new cash registers. IBM knew that DG needed this transaction in order to minimize a negative charge to earnings (or reduction in the reported GAAP net income). The IBM salesmen proposed the modified deal in order to alleviate DG's accounting concern.

IBM had evaluated the old cash registers and determined them to be worthless. They added money to the purchase contract to cover the costs of dumping the obsolete equipment. IBM never took possession of any of the old cash registers.

These transactions were papered as two separate contracts (i.e. transactions). IBM even paid bonuses on the inflated sales price of its new cash registers to its salespeople.

An investigation at IBM was conducted and it uncovered other accounting problems.

The moral of this story is in part - IF IT SEEMS TOO GOOD TO BE TRUE, THE PAPERED CONTRACTS (IE: TRANSACTIONS) MAY NOT REFLECT THE TRUE ECONOMICS.

A MORE RECENT CASE: HP'S ACQUISITION OF AUTONOMY

Information made public to date indicates that Hewlett-Packard ("HP") bought British specialty software firm Autonomy for $12.1 billion based on inflated sales and other fraudulent accounting. In the fourth quarter of 2013 HP took an impairment charge of $8.8 billion. HP disclosed that the majority of this charge (write-off) is related to serious accounting improprieties, disclosed failures, and outright misrepresentations at Autonomy prior to HP's acquisition. Published accounts further indicate that the identification of the misstatements started when a senior member of Autonomy management came forward. HP then began an internal investigation and subsequently contacted the SEC enforcement division and the U.K.'s serious fraud office.

SUMMARY AND CONCLUSION

There are several key lessons here. Fraud is elusive and is only limited to the imagination and creativity of the individual. For this reason you should:

- Know your client.
- Be skeptical.
- Ask yourself whether this transaction/contract makes economic sense.
- Have qualified and knowledgeable experts when and where appropriate to address:
  - Market value issues.
  - Accounting issues.
  - Due diligence.
  - After the fact evaluation of now disputed issues (for example working capital agreements in purchase of businesses).
  - Ask tough questions.
  - Keep your moral compass properly calibrated.

ABOUT THE AUTHORS

Lesley D. Hand, CPA, CFE, CFF
Affiliate, Finance Scholars Group

Lesley D. Hand has over thirty-seven years of forensic accounting experience in several industries, including but not limited to technology, software, manufacturing, consumer markets, government and professional services firms. He has been involved in over 100 investigations related to allegations of earnings management. These investigations have focused on improper revenue recognition, "cookie jar" reserves, improper capitalization of expenses, inappropriate use of inventory reserves, vendor rebates and other types of fraudulent financial reporting. He has attended numerous meetings at and has been deposed by the U.S. Securities and Exchange Commission in connection with his forensic accounting work.