Financial Statement Fraud

Introduction to Financial Statement Fraud
Objectives and Overview

- Introduction
- Management’s and Auditors’ Responsibilities
- Improper Revenue Recognition
- Improper Treatment of Sales
- Improper Asset Valuation
Objectives and Overview

- Improper Deferral of Costs and Expenses
- Improper Recording of Liabilities
- Inadequate Disclosures
- Detecting Financial Statement Fraud
Quotes of the Day:

“The greed of gain has no time or limit to its capaciousness. Its one object is to produce and consume. It has pity neither for beautiful nature nor for living human beings. It is ruthlessly ready without a moment's hesitation to crush beauty and life.”
Quotes of the Day:

“What kind of society isn’t structured on greed? The problem of social organization is how to set up an arrangement under which greed will do the least harm; capitalism is that kind of system.”
Speaker: Milton Friedman

Recipient of the 1976 Nobel Memorial Prize for Economic Science
Quotes of the Day:

“Greed is all right, by the way, ....I want you to know that.”

- Address given to business students
“The point is, you can’t be too greedy.”
Speaker: Donald Trump
Quotes of the Day:

“It’s never going to change. As long as there is a good deal of money to be made on Wall Street, there will always be people of dubious reputation coming up with new ways to fleece the sheep. Welcome to capitalism.”

- By a Wall Street Historian
Stories in the News!!

- Newspapers filled with details of corporate scandal
- One of nation’s largest, most well-respected companies is caught inflating earnings and assets
- Fraudulent manipulation of accounting rules!
- Thousands of investors and employees suffer!
- Cries go up of “Where were the auditors?”
- Accounting profession goes under immense political pressures for reform!
The Year?  1938

The Company?  McKesson - Robbins

The Fraud Amount?
Just $19 million!!
More Recent Headlines!

- “WorldCom Earnings Misstatement Now Up to $11 Billion”
- “U.S. Probes AOL Accounting Practices”
- “More Tech Firms Falsify Sales to Boost Stock”
- “The Art of Creative Accounting”
More Headlines!

- “Report: Enron Execs Hid Losses, Made Millions”
- “Xerox Duplicates Problems”
- “Waste Management Founder, Five Other Former Top Officers Sued for Massive Fraud”
- “Study: Accounting Firms Still Bend Rules to Benefit Big Clients” (10/28/03 Accounting Web)
More Headlines!

- Former HealthSouth President Indicted (02/03/05 Forbes.com)
- SEC Begins Probe of OfficeMax Accounting Problems (06/16/05 Accounting Web)
- Adelphia Founder Rigas Gets 15 Years in Prison (06/20/05 USA Today)
- Enron’s Fastow “Juiced” Books (03/08/06 USA Today)
- HealthSouth Ex-Controller Gets 8 Years in Prison (June 15, 2006 Reuters)
- Fortune Magazine Headline – “You Bought, They Sold”
Qwest ($2.5 billion revenue overstatement)

Global Crossing (understated liabilities $50–$80 million)

Peregrine Systems (40% of revenue over 11 quarters)
Importance of Accurate Financial Information

- Why is accurate financial information important?
  - Financial statements provide meaningful disclosures of...
    - Where a company has been
    - Where a company is currently
    - Where a company is going
Objectives of Financial Reporting (SFAC #1)

Financial statements should provide information useful in making:

• Business and economic decisions
• Reasoned choices among alternative uses of scarce resources
PAST TRUST IN THE RELIABILITY OF FINANCIAL INFORMATION
A NEW VIEW OF MANAGEMENT AND MANY CFOs?
Father to son:

“It all starts with stealing your brother’s chewing gum, Jeffery . . . and before you know it you’re an accountant.”
Quotes of the Day:

“I believe I was extremely greedy and that I lost my moral compass, and I’ve done terrible things that I very much regret.”

- Andrew Fastow (former CFO of Enron, who has pleaded guilty to two conspiracy counts and agreed to serve up to 10 years in federal prison.)
A Rose by Any Other Name…

• Earnings Management
  • Manipulation toward a set target
• Income Smoothing
  • Remove peaks and valleys of a normal income series
• Aggressive Accounting
  • Choice and application of accounting principles
• Creative Accounting
  • All of the above
A Rose by Any Other Name…

- Fraudulent Financial Reporting
  - Can be found in all of the previous activities (but all are NOT necessarily fraudulent)
  - Fraud is intentional
    - Misstatements
    - Omissions
    - Missing disclosures
  - Fraud is designed to deceive the users
A Rose by Any Other Name…

• NEW ACCOUNTING TERM!! “CORKED FINANCIAL STATEMENTS”
  • Yes, the financial statements can be “Sammy Sosa’d.” (Like a corked baseball bat, what you see on the outside is not what is really on the inside!)
Other New Accounting Terms…

- RAIDS – Recently Acquired Income Deficiency Syndrome
- CARAP (Pronounced ca-rap’) – Confusing Application of Recent Accounting Pronouncements
Other New Accounting Terms…

- Fluffy Financials
- Puffy Financial Statements
- Defroging the Financials
- Dangling Debits
- Interventive Accounting Events
- The 35 Day Month
- Flash Periods
Other New Accounting Terms…

“Kicking the T@#%! into the next quarter”
Technical definition: Delaying recognition of bad accounting results

“Dropping a Twinkie®”
Technical definition: Recognition of bad accounting results in the current quarter
Other New Accounting Terms...

- The “Big Bath”
- “Cookie Jar” Reserves
- “Cooking the Books”
Other New Accounting Terms...

“Prestodebitation” – The act of creating financial accounting assets out of thin air!
Other New Accounting Terms…
(The Most Dangerous!)

GASAAP – Generally Accepted South Alabama Accounting Principles!!

(My home state)
GAAP Issues—Flexibility in Selection of Accounting Policies

AccountingWEB.com, Aug. 3, 2005—RateFinancials has released the results of a two-year study that finds companies still take liberties in reporting their financials. Although these statement inaccuracies may not violate GAAP standards, the company’s financial health may not be accurately reflected for intelligent investors and shareholders in clearly worded descriptions.
Occupational Fraud

“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”
Occupational Fraud

- Corruption
- Asset misappropriation
- Fraudulent statements (including financial statement schemes)
Financial Statement Fraud

- Financial statement fraud is the *deliberate misrepresentation* of the financial condition of an entity accomplished through the *intentional misstatement or omission* of amounts or disclosures in the financial statements to *deceive* financial statement readers and users.
Who Commits Financial Statement Fraud?

- Financial statement fraud is perpetrated by anyone who has the opportunity and the motive to omit or misstate the data presented, in furtherance of their purpose.
  - Owners
  - Officers
  - Managers
  - Employees
Who Commits Financial Statement Fraud?


“Speaking with a quick confidence and a matter-of-fact tone, former Enron Treasurer Ben Glisan Jr. told a jury Tuesday that the company was **debt-ridden, financially weak**, that it **manufactured cash flow and earnings**, and his **ex-bosses were misleading the investing public about all of it.**”
Ben Glisan, Jr., (age 34) University of Texas business school graduate who became treasurer of ENRON at age 34

In contrast to his appearance in prison khakis in a 2004 Enron trial, Glisan wore a suit and tie.

“The company could not afford to be honest”
Another Quote of the Day:

“Truth may need no explanation; but a footnote may be necessary.”

- Eli Khamarrov
Financial Statement Fraud

- Financial statement fraud is frequently a means to an end rather than an end in itself.
  - Examples:
    - Buy more time to “fix” a problem
    - Obtain or renew financing
Financial Statement Fraud

- People intent on profiting from crime may commit financial statement fraud to obtain loans they can then siphon off for personal gain or to inflate the price of the company’s shares, thus allowing them to sell their holdings or exercise stock options at a profit.
Financial Statement Fraud

- Financial statement fraud typically involves overstating assets, revenues, and profits and understating liabilities, expenses, and losses.

But it can involve the opposite!! When?
Areas of Fraud Impact

- Share prices
- Borrowing costs
- Incentive compensation
- Regulatory issues (Microsoft example)

(From the book *The Financial Numbers Game*)
Cost of Financial Statement Fraud

- Financial statement fraud typically has a devastating impact on the reputation and the financial position of the entity and people involved.
  - Market capitalization
  - Bankruptcy/ownership change
- Many jobs are lost as companies restructure to restore profitability.
  - Human cost
- Other?
Why Fraud Is Committed

- Most often = more robust reported earnings
  - Apparent Quantity
  - Apparent Quality

- Labeling it as fraud
  - Easy
  - Complex
    - Valuation judgments
    - Complex accounting issues
    - The “oops” factor
    - Hindsight?
“You want to show that matters of judgment are not matters of criminality. What’s happened in the last few years is that people have used hindsight to label as criminal things that at the time were considered cutting-edge.”

- David Schertler, attorney (www.cfo.com) (02/01/06)
Why Fraud Is Committed?

- To meet Wall Street analysts’ expectations
- To encourage investment in the company through the sale of its stock
Why Fraud Is Committed?

- To demonstrate increased earnings per share or partnership profits interest, thus allowing increased dividend or distribution payouts
- To cover an inability to generate positive cash flows
Why Fraud Is Committed?

- To dispel negative market perceptions
- To obtain financing, or to obtain more favorable financing terms
- To receive higher purchase prices for acquisitions
Why Fraud Is Committed?

- To demonstrate compliance with financing covenants
- To meet company goals and objectives
- To receive performance-related bonuses
- To increase stock value for acquisitions involving stock swaps
The Fraud Triangle

- Pressure (Need and Greed)!
- Opportunity!
- Rationalization!
The Fraud Triangle

Incentive
(Pressure)

Opportunity

Rationalization
(Attitude)
Examples of situational pressures include:

- Sudden decreases in revenue or market share
Examples of situational pressures include:

- Unrealistic budget pressures, particularly for short-term results (the pressures become even greater with arbitrarily established budgets that are without reference to current conditions)
Examples of situational pressures include:

- Financial pressures resulting from bonus plans that depend on short-term economic performance (these pressures are particularly acute if the bonus is a significant component of the individual’s total compensation)
At HealthSouth, we’re excited about the future of healthcare – and the future of our company. 2001 proved to be a year that clearly defined HealthSouth as the Fortune 500 company that will lead the way into a new era of healthcare.

“In 2001, we set new records as we pushed our revenues well over $4.3 billion and celebrated another year of fulfilling Wall Street expectations, maintaining our record as the Fortune 500 company with the second-longest streak for meeting or exceeding analysts’ expectations.”

RICHARD M. SCRUSHY
Chairman of the Board & Chief Executive Officer
HealthSouth

More new accounting terms:

- “Dirt” – bogus accounting entries made to fill the gap between reality and Wall Street expectations
- “Scrushyed” – as in the accounting records were “scrushyed”
Other New Accounting Terms (HealthSouth)…

- “Gifts”
- “Pixie dust”
- “Fairy dust”
- “Candy”

These were references by managers to the unanticipated and unexplained improvements shown on their **finalized** financial reports.
HealthSouth Allegations of Pressure, Creating Fraud Opportunities

“… Company employees testified about a company culture of fear and intimidation.”

Reuters (10/16/03)
HealthSouth Allegations of Pressure, Creating Fraud Opportunities

"When I realized something was wrong, I understand I should have come forward. But in the situation I was in, I felt trapped. I was afraid of losing my job. I was afraid of my husband losing his job because he worked there," she said. Both were fired.
WorldCom—Downward Pressure

“The source of the pressure was Bernie (Ebbers) and the source of the pressure was the marketplace.”

- Scott Sullivan (Ex-CFO)
Scott Sullivan
(Ex-CFO of WorldCom)
WorldCom—Downward Pressure

- “Ms. Vinson (accountant) felt trapped”
- “She was the family’s main breadwinner”
- “She was anxious about entering the job market as a middle-aged worker”
  - She began to rationalize her decision to comply…
“She lived and worked in Jackson, Mississippi, where it wasn’t easy to find well-paying work”

RESULT?

- She made the transfers.
- She decided into which of the five capital accounts the line costs would be moved.
  - She was indicted as a co-conspirator.
ENRON—Pressure (Meet Analyst’s Expectations) (USA Today 02/21/06)

“Jeff Skilling (CEO) ordered a penny increase in earnings per share … to match analyst’s expectations of 31 cents per share.” (4th Qtr 1999)

“Skilling ordered a two-cent hike to reported earnings per share right before the figures were officially released.” (2nd Qtr 2000)
Fannie Mae (Earnings Management Allegations)—Pressures

- Roger Barnes (accounting manager)—testimony before House Committee on Financial Services
  - Stripped of duties
  - Bosses said the CPA and MBA did not understand accounting
  - Felt “chill and humiliation after he started questioning the legality of the company’s accounting”
  - “My (personnel) evaluation contained negative comments about my ‘communication’ and other interpersonal skills.”
- He described a company culture that uses threats, intimidation and reprisal against employees who raise red flags
Some of the more obvious opportunities for the existence of fraud include:

- The absence of, or improper oversights by, the board of directors or audit committee, or the neglectful behavior of the board or committee
- Weak or nonexistent internal controls, including an ineffective internal audit staff and a lack of external audits
Some of the more obvious opportunities for the existence of fraud include:

- Unusual or complex transactions (an understanding of the transactions, their component parts, and their impact on financial statements is paramount to fraud deterrence)
Some of the more obvious opportunities for the existence of fraud include:

- Financial estimates requiring significant subjective judgments
Example of Lack of Oversight and Downward Pressure: Qwest Communications ($2.2 Billion Fraud Allegation)

Actual e-mail quote from one company director to another stated that there were

“…well known consequences for not making the numbers (hitting earnings targets) but no clear consequences for cutting corners.”
Rationalizations

- Asset Misappropriation
  - “I deserve it”
  - “I’m underpaid”
  - “I’ll repay it”

- Financial Statement Fraud
  - “It’s just a timing issue”
  - “Everyone else is doing it”
  - “We’re protecting shareholder value”
HealthSouth Rationalizations, Creating Fraud Opportunities

"I was instructed by my superiors to do things that I did not know were wrong at first," said Valentine, 34.
Morgan, 56, accepted responsibility for helping in the fraud—actions she said were prompted by intimidation, fear, and a misplaced trust in her superiors. "I believed what we were doing was temporary," said Morgan.
"I thought I was doing what was best for the company. I wish I hadn't made that decision," Bill Owens said.

- (Former CFO of HealthSouth)
During cross examination, Bill Owens was asked to repeat a statement made several years ago at his wife's birthday celebration.

"I made the statement that I believe that I'm the smartest person alive," Owens said.

"But you are the smartest man alive?" Parkman (Scrushy’s attorney) asked.

"I believe that," said Owens, who faces as many as 30 years in prison.
"I thought I was being a hero for Enron. At the time, I thought I was helping myself and helping Enron make its numbers."

- (Andrew Fastow, Former CFO of Enron)
WorldCom—Rationalization

- “Mr. Myers (controller) assured him (Normand) it would never happen again.”

- Scott Sullivan (CFO) to accountants: “We have planes in the air. Let’s get the planes landed. Once they are landed, if you still want to leave, then leave. But not while the planes are in the air.”

- Mr. Sullivan said he would assume all responsibility

- Ms. Vinson began to rationalize—If Sullivan, one of the top CFOs in the country, thought it was all right, who was she to question it?
FRAUD RATIONALIZATION:
Adelphia Communications

John Rigas (80 yrs old, sentenced to 15 years)

“In my heart and conscience, I’ll go to my grave believing that I did nothing but try to improve conditions.”
FRAUD RATIONALIZATION: Adelphia Communications

Timothy Rigas
(48 yrs old, sentenced to 20 years)

“Our intentions were good.”

• $2.3 billion in off-balance-sheet debt.
• Family owned businesses used to steal $100 million for personal use.”
Effects of Financial Statement Fraud
(Six Common Areas)

- Improper Revenue Recognition
- Improper Treatment of Sales
- Improper Asset Valuation
- Improper Deferral of Costs and Expenses
- Improper Recording of Liabilities
- Inadequate Disclosures
Financial Statement
Fraud Definitions

- **Fraud** consists of one or more intentional acts designed to deceive other people and cause them financial loss.
Financial Statement Fraud Definitions

Financial Statements

- AU 623, Special Reports defines a financial statement to include presentations of financial data and accompanying notes prepared in conformity with generally accepted accounting principles (GAAP) or another comprehensive basis of accounting, as follows:
Financial Statements

- Balance sheet or statement of assets and liabilities without owner’s equity
- Statement of income, statement of operations, statement of revenues and expenses, or statement of cash receipts and disbursements
Financial Statements

- Statement of retained earnings or statement of changes in owner’s equity
Financial Statements

- Statement of cash flows
- Summary of operations and statement of operations by product lines
Other Types of Financial Statements

- Prospective financial information (forecasts)
- Proxy statements
- Interim financial information (quarterly financials)
- Current value financial presentations
Other Types of Financial Statements

- Personal financial statements (current value)
- Bankruptcy financial schedules
- Registration statement disclosures (Securities Act of 1933)
Fraud is generally understood to consist of one or more intentional acts designed to deceive other persons and cause them financial loss.

Financial statement fraud may be considered deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.
Intent

- Intent, according to Black’s Law Dictionary, is the design, resolve, or determination with which a person acts.
Most Difficult Element of Fraud to Prove??

- **INTENT!!**
  - Especially in areas where significant professional judgment is required
  - Examples:
    - Determination of accounting estimates
    - Application of accounting principles in complex situations (revenue recognition, etc.)
**CEO Defensive Strategy**

- Kenneth Lay (Enron)
- Richard Scrushy (HealthSouth)
- Bernard Ebbers (WorldCom)
The “Looney Tunes” Defensive Strategy

Pleading ignorance (lack of knowledge) of the major events happening within the company

“This is what I call the Elmer Fudd Defense—that I went to work every day and was paid $6 million a year and had a Ph.D. in economics—and somehow, despite all of this, I didn't know anything that was going on. It's laughable,” says Bill Lerach, a lawyer who sued to stop document shredding by Enron’s accountants.
Same Defensive Strategy

The Sgt. Shultz Strategy

“I know NOTHING!!!”
Same Defensive Strategy

“The Four Monkey Strategy”

- I did not say
- I did not do
- I did not see
- I did not understand

-Harvey Pitt (Former Head of SEC)
“Jury Convicts WorldCom's Ebbers” (USA Today 3/15/05)

“Ebbers, 63, was charged with fraud, conspiracy, and filing false documents with regulators—all of which relate to the $11 billion accounting scandal at the telecommunications company he founded. He faces up to 85 years in prison.”
Bernie Ebbers (with wife) after his conviction (03/15/05)
More Headlines!

“Scrushy Acquitted of Fraud at HealthSouth”  (Business Week Online 6/28/05)

“Scrushy walked away a free man Tuesday after a jury cleared him of all charges in a stunning setback for federal prosecutors.”

“Scrushy still faces civil charges filed by the SEC, which some experts say are more likely to be successful for the government.”
No Proof of INTENT: Scrushy Jury

While the government presented a strong case, it did not present a perfect case because there are no perfect cases. All FIVE former CFOs said Scrushy knew of the fraud and directed it, but:

• There were no e-mails or documents linking Scrushy to the fraud.
• There was no smoking gun pointed directly at him.
• The government was forced to rely on the testimony of witnesses who admitted committing crimes and benefiting from those crimes.
"We needed to see his fingerprints on one of the documents…"

"They always do fingerprints on TV" (the CSI effect)

"As for evidence, I wanted something in black and white, something like fingerprints. That wasn't there."

"There were a lot of holes that weren't filled in for me," said one juror.

Some jurors said, “I disregarded everything they (the ex-CFOS pleading guilty) said.”

Others viewed the ex-CFOS as "snitches" and didn't trust them.
Proof of INTENT: Scrushy Jury

- The Associated Press reported that one juror said, "The fraud was there; the smoking gun wasn't."
- “We needed him (Scrushy) to say the word fraud on the audiotape,” said one juror.

FACTS:
- He did say things like:
  - “Fix it.” (referring to the financial statements)
  - “You’re not wired, are you?”
Proof of INTENT: Lay Defense

1. We did not know!!
   PLUS!!

2. There was no widespread fraud
   • Only lesser crimes by former finance chief
   • Bad press
   • Market pressures that took it down
Legal experts also said they were surprised Lay and Skilling based their entire defenses on the idea that there was no overarching fraud at Enron when they took the witness stand.

David Berg, a Houston civil litigator who has published a book about juries, called it "the Peter Pan defense—clap real hard and Enron will reappear, and nothing wrong happened. Well, plenty wrong happened."
Lay, Skilling found guilty

USA Today (5/26/06)
HOUSTON (AP) — Former Enron Chief Executive Officer Jeffrey Skilling was sentenced Monday to 24 years and four months in the harshest sentence yet in the case that arose from the energy trading giant’s collapse.
THE CASE AGAINST
JEFF SKILLING

ENRON PROSECUTORS HAVEN’T BEEN
DRAGGING THEIR FEET. THE PROBLEM IS,
WITH FEW OF THE EX-CEO’S DIRECTIVES
IN WRITING, THERE ARE NO
SMOKING GUNS.
"The defense was built around a reliance on auditors, attorneys, and staff, and trying to get people to believe that as CEOs, they knew absolutely nothing about fraud when they were getting paid millions," says Lynn Turner, former chief accountant of the Securities and Exchange Commission. "Other executives are going to understand that this type of defense isn't plausible anymore."
Jurors: Ex-Enron execs not credible

According to the jury, Skilling was undone by his own brilliance. "For a man who knew every aspect of the business, why didn't he know what was going on?" asked juror Doug Baggett.

Worse than Lay's demeanor on the stand, jurors said, was evidence presented by the government that while Enron was collapsing, he quietly sold $70 million in stock back to Enron while urging employees to buy more.
Supreme Court to Hear Appeal of Enron's Skilling (10/14/09 WSJ)

- The justices agreed to look at two issues in the appeal of Mr. Skilling's 2006 conviction that could have broader repercussions, say legal observers. One deals with the government's contention that Mr. Skilling violated his legal obligation to provide "honest services" to Enron shareholders because he lied about the energy-trading company's financial condition before it collapsed into bankruptcy in December 2001. Mr. Skilling's attorneys maintained that prosecutors misapplied the honest-services statute, arguing their client hadn't lied and didn't cheat Enron or its shareholders.

- The second issue involves Mr. Skilling's claim that he wasn't able to get a fair trial in Houston, site of Enron's headquarters, because of anger in the community over the company's collapse.

- Mr. Skilling was also convicted of insider trading
PROVING INTENT?

- Intent is an attitude of the mind
- Reliance on circumstantial evidence!
- Observed conditions could be
  - Fraud?
  - Mistakes?
  - Oversight?
  - Coincidence?

(Don't jump to conclusions!)
Stronger Evidence of Intent

- Repeated indications of fraud
- Obvious forgeries
- Obvious fictitious entries
- Your seasoned professional judgment
- Resurrected e-mails and other documents
- CONFESSION!
NEW YORK (CNNMoney.com) -- Kenneth Lay, who rose from a poor preacher's son to become a millionaire before being convicted of corporate fraud, died early Wednesday in Aspen, Colo., a family spokeswoman said. Lay, 64, was awaiting sentencing after being found guilty of conspiracy and fraud in the Enron trial in May.
Update: This Time, Scrushy Convicted

(WSJ: June 29, 2006)

“A federal jury in Montgomery, Ala., has convicted HealthSouth founder Richard Scrushy of charges he bribed former Alabama Gov. Donald Siegelman for a seat on a hospital regulatory board. It was a victory for the federal government. Prosecutors failed last year to convict Mr. Scrushy on charges related to the massive accounting fraud at HealthSouth.”
Scrushy Gets Nearly Seven Years in Prison (USA Today 6/29/07)

“Former HealthSouth CEO Richard Scrushy was sentenced Thursday night to six years and 10 months in federal prison for his bribery conviction in a government corruption case.”
Scrushy’s boat

My boat
Breaking News
August 20, 2009

**RICHARD M. SCRUSHY FOUND GUILTY OF FRAUD**

*Plaintiffs Awarded A Total of $2.876 Billion*

John W. Haley, lead counsel for the plaintiff's firm Hare, Wynn, Newell & Newton, said, "The ruling in this historic case is a shot across the bow for those who engage in corporate greed and fraud in our country. In fact, this is much more than a shot across the bow ... it is a full broadside and a tremendous victory for the shareholders of HealthSouth."
Materiality

“A fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in making an investment decision or it would have significantly altered the total mix of information made available.”
Materiality—FACS#2 Definition

“Magnitude of an omission or misstatement ... that in light of surrounding circumstances makes it probable that the judgment of a reasonable person ... would have been changed or influenced.”
"These figures are very upsetting. Don’t you have something a little less accurate?"
Another “Material” Thought for the Day

“There are no small frauds—just big frauds caught early.”
GAAS Observation

“Financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly…”
Causes of Misstatements

Causes

Errors

Fraud

Misappropriation of Assets

Financial Reporting
Financial statements are materially misleading ("fraudulent") when the presentation contains fictions, improper valuations, inappropriate transaction timing, omissions, and false statements that are important enough to affect decisions that the users of the statements wish to make.
When the “Immaterial” Becomes Material

- Hides a failure to meet an analyst’s expectations
- Masks a change in an earnings trend
- Affects regulatory compliance
- Hides a loan covenant violation
- Conceals an unlawful transaction
Double Entry Accounting

- Fraudulent accounting entries always affect two accounts and typically two different financial statements (e.g., balance sheet and income statement), although balance sheet reclassifications can bury liabilities as well.
Survey participants estimated that the typical organization loses 5% of its annual revenue to fraud. Applied to the estimated 2009 Gross World Product, this figure translates to a potential total fraud loss of more than $2.9 trillion worldwide.

The median loss caused by the occupational fraud cases in the study was $160,000. Nearly one-quarter of the frauds involved losses of at least $1 million.
Asset misappropriations were the most common (86% of cases) and the least costly ($135,000 median loss).

Financial statement fraud schemes were least common (5% of cases) but by far most costly ($4.1 million median loss).

Corruption schemes fell in middle in both respects.
Ongoing Nature of Fraud—Another Quote

“I don't know why I did it . . . I don't know why I enjoyed it . . . I don't know why I'll do it again . . .”

- As spoken by?
Noted Fraudster—Bart Simpson
Ongoing Nature of Fraud

"Unfortunately, it is a line that once you cross it, it is difficult to cross back," Bill Owens said.

(Former CFO of HealthSouth)
Ongoing Nature of Fraud

“The foundation was crumbling and we were doing everything we could to **prop it up**.”

(Andrew Fastow, Former CFO)
Occupational frauds are much more likely to be detected by a tip than by audits, controls, or any other means.
Detection Methods—2002 ACFE Report to the Nation

<table>
<thead>
<tr>
<th>Initial Detection Method/Percent of Cases of Frauds</th>
<th>Cases</th>
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<tbody>
<tr>
<td>Tip from Employee (26.3%)</td>
<td>140</td>
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<tr>
<td>By Accident (18.8%)</td>
<td>100</td>
</tr>
<tr>
<td>Internal Audit (18.6%)</td>
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<td>Internal Controls (15.4%)</td>
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<tr>
<td>External Audit (11.5%)</td>
<td>61</td>
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<tr>
<td>Tip from Customer (8.6%)</td>
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<tr>
<td>Anonymous Tip (6.2%)</td>
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<tr>
<td>Tip from Vendor (5.1%)</td>
<td>27</td>
</tr>
<tr>
<td>Notification by Law Enforcement (1.7%)</td>
<td>9</td>
</tr>
</tbody>
</table>

66.7% by tips or simply by accident
Detection Methods—2006 ACFE Report to the Nation

- Tips – 34.2%
- By Accident – 25.4%
- Internal Audit – 20.2%
- Internal Controls – 19.2%
- External Audit – 12.0%

- Tips and by accident = 59.6%!!!
- External audit improvement since 2002 (from 11.5% to 12.0%)
Detection Methods—2008 ACFE Report to the Nation

- **Tips** – 46%
Detection Methods—2010 ACFE Report to the Nations

- Tip: 40.2%
- Management Review: 15.4%
- Internal Audit: 13.9%
- By Accident: 8.3%
- Account Reconciliation: 6.1%
- Document Exam: 5.2%
- External Audit: 4.6%
- Surveillance/Monitoring: 2.6%
- Notified by Police: 1.8%
- Confession: 1.0%
- IT Controls: 0.8%
Case Study—Employee Tips

Southeastern distributor of packing material

Audit committee gets **employee tip** – Controller and vendor have a scheme (collusion) – $100,000

Interview key personnel and review selected documents to **establish predication** (reasonable possibility that a fraud could and did occur)

Financial statement **ratio analysis**

Saw **trucking costs double % at one location** (trends)
Case Study—Employee Tips

- Discovered Controller has a yacht!
- Truck engine repair costs = boat repair ($63,000)
- Real estate commission kickbacks ($50,000)
- Truck tire purchases = appliances for personal condo
- Purchasing manager implicated also
- Condo expenses paid by company (son’s too)
- Final tally $300,000 (three times the tip)
Case Study—Employee Tips

- Mirrored his computer hard drive at office
- Restored deleted files, website traffic (porn), and e-mails
- E-mails discuss scheme
- Key to condo location! (location, location, location!)
  - Weekly girlfriend getaway!
- Uncooperative with inquiries
- Attempt to reconstruct his personal net worth
Case Study—Employee Tips

- Initial Audit Committee reaction?
- Ultimate termination
- Profits after termination
  - His last year—Losses!
  - First year after termination—$600,000 profit
  - Next year? $3.6 million profit
- What was the true loss?
2010 Report to the Nations—Executive Summary

- Small organizations are disproportionately victimized by occupational fraud.
- The industries most commonly victimized in the study were the banking/financial services, manufacturing, and government/public administration sectors.
Computer hardware and software companies topped the list of those involved in financial statement fraud.

- Computer companies
- Other manufacturers
- Financial service providers
- Health care and health product providers
- Other service providers
- Retailers and wholesalers
- Oil and gas drilling
- Telecommunications
- Insurance
- Real estate
- Other

**PERCENTAGE OF COMPANIES IN WHICH FRAUD OCCURRED**
2010 Report to the Nations—Executive Summary

- Anti-fraud controls appear to help reduce the cost and duration of occupational fraud schemes.
2010 Report to the Nations—Executive Summary

- High-level perpetrators cause the greatest damage to their organizations.
- More than 80% of the frauds in the study were committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service, or purchasing.
2010 Report to the Nations—Executive Summary

- More than 85% of fraudsters in the study had never been previously charged or convicted for a fraud-related offense.
- Fraud perpetrators often display warning signs that they are engaging in illicit activity. The most common behavioral red flags displayed by the perpetrators were living beyond their means and experiencing financial difficulties.
Occupational fraud and abuse is a serious problem facing organizations throughout the world.
2010 Report to the Nations—Conclusion

- Cash is the asset most frequently targeted by the fraudster.
- Many occupational frauds are ongoing.
- The single most effective method of detecting occupational fraud is through tips and complaints.
- Fraud reporting mechanisms are a critical component of an effective fraud prevention and detection system.
Employee education is an important aspect of preventing fraud.

Small businesses are especially vulnerable to occupational fraud and abuse.

The most costly frauds are committed by well-educated senior male executives.

Internal controls alone are insufficient to fully prevent occupational fraud.
In March 2007, the U.S. Government Accountability Office (GAO) issued a revised update to its 2002 report.

To update the information in the original, the GAO undertook a similar analysis of 1,390 public company restatements that occurred between January 1, 2002, and September 30, 2005.
The COSO Study

Financial Statement Fraud Statistics

- A Few Interesting Facts Revealed in the COSO Study of Financial Statement Frauds that Occurred Between 1998 and 2007:
  - The average fraud period extended 31.4 months.
  - The two most common techniques used to fraudulently misstate the financial statements involved improper revenue recognition and asset overstatements.
Financial Statement Fraud Statistics

- A Few Interesting Facts Revealed in the COSO Study of Financial Statement Frauds that Occurred Between 1998 and 2007:
  - The mean cumulative financial statement misstatement was $397.68 million.
  - The median cumulative financial statement misstatement was $12.05 million.
Financial Statement Fraud Statistics—COSO (continued)

- The CEO was most often named as a perpetrator, being named in 72% of the cases.
- The CFO was named as a perpetrator in 65% of the cases.
- The CEO and/or CFO were named for some level of involvement in 89% of fraud cases.
Most commonly cited motivations for fraud:

- Meet internal or external earnings expectations.
- Conceal company’s deteriorating financial condition.
- Increase stock price.
- Bolster performance for pending equity or debt financing.
- Increase management compensation.
Financial Statement Fraud Statistics—COSO (continued)

- 26% of fraud firms vs. 12% of no-fraud firms changed auditors between the period that the company issued the last clean financial statements and the period the company issued the last set of fraudulent financial statements.
- Long-term negative consequences of fraud include: bankruptcy, delisting from stock exchange, and material asset sales.
Audit Risk Model

(SAS 107.21-26)

- Audit Risk – Risk that the auditor issues the wrong opinion. That is, he fails to qualify the opinion when there is a material misstatement.
- Therefore, audit risk (AR) consists of two parts:
  1. Risk of Material Misstatement (RMM)
  2. Detection Risk (DR)

\[ AR = RMM \times DR \]
Audit Risk Model

- **Risk of Material Misstatement** consists (is a combination) of two parts:
  1. **Inherent Risk** – susceptibility to material misstatement assuming no related controls
  2. **Control Risk** – risk that a material misstatement would not be prevented or detected on a timely basis by internal control

\[
RMM = IR \times CR
\]

*RMM exists independent of the audit.*
Assessing **Inherent Risk**

- Some accounts by their nature are more susceptible to misstatement
  - Fair value in certain accounts — Subjective estimates (examples?)
  - Complex calculations
    - Asset impairment using DCF
    - Asset retirement obligations
    - Reserves and allowances

- Some accounts are more susceptible to fraud
  - Cash
    - Cash is more susceptible to fraud from theft than to fraud from financial reporting (but sales would be the opposite)
  - Large accounts with complex fair value calculations

- Material balance and volume of transactions in the account?
Audit Risk Model
(Another Component = DR)

- **Detection Risk** = The risk that the auditor’s procedures will not detect a misstatement in a relevant assertion that could be material, either individually or when aggregated with other misstatements.
Audit Risk Model

- Detection Risk is a function of the effectiveness of the audit procedures (how much work the auditor does and how well he does it) and consists of:
  1. Tests of Details Risk
  2. Substantive Analytical Procedures Risk

\[
DR = TD \times AP
\]

Substantive Audit Procedures
Audit Risk Model (Review)

\[ AR = RMM \times DR \]

\[ RMM = IR \times CR \]
\[ DR = TD \times AP \]

- Susceptibility to material misstatement assuming no controls
- Risk that material misstatement would not be prevented/detected by internal control
- Risk that the audit procedures will not detect a material misstatement
- Test of details
- Analytical procedures