Financial Statement Fraud

Improper Deferral of Cost of Expenses
Introduction

- Capitalizing Expenditures
- Changing Accounting Policies
- Improper Amortization
- Failure to Impair Assets
- Reducing Asset Reserves
Capitalizing Expenditures

- Advertising and Marketing
- Software Development
- Start-Up Costs
- Repairs and Maintenance
In-Process Research and Development

- R&D assets are no longer immediately charged to expense
- Regardless of whether the assets have an alternative future use, they shall be considered as indefinite-lived until the R&D efforts are completed or abandoned
- Like other indefinite lived assets, impairment testing is required under SFAS 142
- When the R&D effort is complete, useful life is assigned
- Costs incurred after the acquisition date are expensed as incurred if used in R&D activities with no alternative use
Changing Accounting Policies

- Pushing costs to future periods by improperly capitalizing expenditures only serves to defer the inevitable recognition of these expenditures.
Fair Value Option (SFAS No. 159) and New Fair Value Measurement Issues

Permits all entities to choose, at specified election dates, to measure eligible items at fair value. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date.
**Election Date for Fair Value Treatment**

- When the entity **first recognizes** the eligible item
- When the entity enters into an **eligible firm commitment**
- When the accounting treatment for an investment in another entity changes for specified reasons
  - The investment becomes subject to the **equity** method of accounting
  - The investor **ceases to consolidate** a subsidiary or VIE, but retains an interest.
SFAS Election

- The reporting entity’s opportunities for fair value election fall into two basic categories:
  - At initial adoption of the standard, the entity may reclassify any existing eligible asset or liability to fair value. Any gain or loss resulting from reclassification is reported as a cumulative adjustment to retained earnings.
  - Subsequent to initial adoption, the entity may elect fair value at the initial recognition of any eligible financial asset or liability, or upon any event that gives rise to a new accounting basis for that item.
Less-Than-Honorable Intentions?

A company selects an eligible financial asset or liability that will be marked to market and recorded at fair value. When the asset or liability is remeasured, the change—whether it is a loss or gain—is entered directly into the equity section of the financial statements as retained earnings, rather than run through the income statement. This one-time, direct posting to retained earnings is part of the rule's transition provision, and reflects the prospective nature of fair value (fair value is calculated at current prices), rather than the retrospective nature of a historical cost allocation. Because the gain or loss is not reflected in the income statement, there is no charge to earnings.
however, if a company has less-than-honorable intentions, it could use FAS 159 the way many investment advisors have suggested:

- First, identify all the losers in a company's investment portfolio—for example, held-to-maturity stocks that are underwater or available-for-sale loans that have interest rates much higher than current market rates. Next, apply FAS 159, and elect to fair value the underwater stocks or expensive loans. Then, calculate the remeasured loss, bypass the income statement, and record the loss in retained earnings. Finally, have the company sell-off the stock or refinance the loan, and immediately turn around and purchase a replacement instrument that is valued at historical cost, dropping the fair value treatment altogether.
FAS 159 clearly articulates the principles and objectives of the standard. Principles-based standards should be applied in a good faith manner consistent with those objectives and principles.

In those situations where early adoption of FAS 159 is deemed appropriate, and where unrealized losses are being recorded directly in retained earnings in connection with the early adoption of FAS 159, entities should provide clear and transparent disclosures of the reasons for electing the fair value option for specific eligible items and for not electing the fair value option for other eligible items within a group of similar items, including a discussion of any accounting motivations of such elections, with the other required disclosures of FAS 159.
Improper Amortization

In accordance with the “matching principle,” expenditures that legitimately qualify for capitalization should be depreciated or amortized over the period(s) in which the expenditures are benefiting.
Failure to Impair Assets

- Without the comparable experience and knowledge typically possessed by management, examiners are faced with the challenging task of identifying impaired assets and calculating the amount of the asset’s impairment.
Examples of Assets Reserves Are:

- Allowance for doubtful accounts
- Allowance for inventory excess and obsolescence
- Accumulated depreciation and amortization
RECEIVABLES FRAUD AND ASSET MISAPPROPRIATION

MCI Alleged Schemes

- “Pretty up” the company for possible sale
- Pressure to increase revenues
- Pressure to control reported bad debts
- Pressure to stay employed
FINANCIAL FRAUD AND ASSET MISAPPROPRIATION

- Ethical message from the “top”? YES!
- Impact on lower levels—YES!
- Focus on financial schemes provided the “Opportunity” for asset misappropriation (theft) to occur
MCI/PAVLO’S CORPORATE BAG OF TRICKS

- De-Aging of A/R
- Misapplication of cash receipts
- Post-dating of invoices
- Placeholder credits
- Factoring of accounts—MCI guarantee?
PAVLO’S PERSONAL BAG OF TRICKS

- Telemedia Networks—MCI creditor
- Orion Management—supposed to pay off the A/R—for a slight fee
PAVLO’S PERSONAL BAG OF TRICKS

- The scheme—Telemedia pays fee to Orion
- Orion never pays MCI
- Telemedia A/R disappears via prior corporate tricks learned by Pavlo
- Party time!! (scheme repeated six more times)
RATIONALIZATION:

“I started out as a company man but abandoned that to act selfishly, as I believed others were doing. I was wrong—BUT SO WERE THEY”

-Walter Pavlo
Forensic Accounting Investigative Techniques

- Deferring costs that should be charged to expense
- Overstating the value of intangible assets
Analytical Fraud Symptoms—Deferred Charges

- Examine changes in the deferred charge (deferred expenses) financial statement relationships from period.
- Compare the financial statement amounts and capitalization policies with those of other, similar companies.
- Be concerned, for example, if deferred charges make up a major portion of a company’s total assets.
Analytical Fraud Symptoms—Deferred Charges

- Probably the most appropriate financial statement relationships to focus on would be the following:
  - Total Deferred Charges/Total Assets
  - Total Deferred Charges/Total Intangible Assets
  - Deferred Charge Write-offs (Amortization)/Deferred Charge Balance
Finite Lived Intangible Assets
Useful Life of an Intangible Asset

- Factors that should be considered:
  - Expected use of the specific asset
  - Expected use of similar assets
  - Legal, regulatory, and contractual provisions that may limit the useful life or enable renewal or extension
  - The effects of obsolescence, demand, competition, and other economic factors
  - What are the required future maintenance expenditures?
Useful Life of an Intangible Asset

- Often, the remaining useful life of an asset is the shortest life of the following:
  - **Legal life**—The asset has legal protection such as a patent, trademark, or copyright.
  - **Contractual life**—Contractual term involving the intangible asset, such as a lease, customer agreement, or supplier agreement, including consideration of possible renewal periods.
  - **Functionality and technological issues**—An asset’s life may be limited by expected improvements in technology. For example, the life of software that is continuously updated is defined by functionality and technological issues.
Useful Life of an Intangible Asset

• *Economic life*—Economic life is the period during which the intangible asset generates positive cash flow.

• *Analytical (actual turnover)*—The analytical factor is based on a statistical analysis of turnover trends. This analysis can be performed on such intangible assets as customer lists.
FAS 144 (ASC 350 and 360)—Impairment Testing for Long-Lived Assets

- This statement retains the requirements of Statement 121 to (a) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (b) measure an impairment loss as the difference between the carrying amount and fair value of the asset.

- The recognized impairment reduces the carrying value of the asset.
Impairment Testing for Assets Subject to Amortization

- Long-lived assets are tested for impairment if certain triggering events occur.

- Examples of “triggering events”:
  - A significant decrease in the market price of a long-lived asset (asset group)
  - A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
  - A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
Impairment Testing for Assets Subject to Amortization

• An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

• A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of the long-lived asset (asset group)

• A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life