Financial Statement Fraud

Inadequate Disclosures
COSO Study—Frequency of Schemes

- Inappropriate Disclosure = 8%
Introduction

- Accounting principles require that financial statements include all the information necessary to prevent a reasonably discerning user of the financial statements from being misled.
Introduction

Improper disclosures relating to financial statement fraud typically involve the following:

- Liability Omissions
- Subsequent Events
- Management Fraud
- Related-Party Transactions
- Accounting Changes
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.
Questions and Obfuscating Language

- What transactions?
- How much money is involved?
- What risk is there to Enron?
- Who is the senior officer of Enron?
- How much is he or she paid?
- Who are the limited partners?
- What basis is there for management's belief that the terms of these transactions "were reasonable compared to those which could have been negotiated with unrelated parties?"
Note 16 Continued

- 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 interests in 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 14.5 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.
Are the Disclosures in the Report “Foggy”?

Robert Gunning's Fog Index is roughly based on sentence length and the number of syllables per word, and its output is the approximate U.S. grade level required to immediately comprehend the text.
Examples: Score of “1”

Come, Dick,
Come and see.
Come, come.
Come and see.
Come and see Spot.

Look, Spot.
Oh, look.
Look and see.
Oh, see.
Example:

Score of “1.5”

Sally said, “Oh, Spot!
Look in here.
Do you see what I see?
It is something we like.”
Examples:

- TV Guide = 6
- True Confessions = 7
- Ladies’ Home Journal = 8
- Reader’s Digest = 9
- Newsweek = 10
- Time Magazine = 11
- Atlantic Monthly = 12
- The Audit Report = ??
The word logorrhea is often used pejoratively to describe prose and audit report language that is highly abstract and contains little concrete language. Since abstract writing is hard to visualize, it often seems as though it makes no sense and all the words are excessive. Writers in academic fields that concern themselves mostly with the abstract (such as philosophy, postmodernism, and highly-trained CFEs) often fail to include extensive concrete explanations of their conclusions, and so a superficial examination of their work might lead one to believe that it is all nonsense.
Lack of Clarity in Reporting

“The significance of the CIE (current year income effect) in the log linear analysis is incremental to the significance of the CIE x structuring and CIE x precision interactions. However, a test of equal proportions indicates that the proportion of CIEs that are income increasing (63%) differs significantly from 50%.”

*Fog index = !@#$!!*
ADELPHIA

- Numerous undisclosed related-party transactions
  - Board
  - Officers
    - $12.8 million golf course on personal land
    - $300,000,000 to senior management
  - Controlled entities
- Lies in press releases
  - Subscriber numbers
  - Cable plant upgrades
  - Earnings
Example: MCA Financial Corporation

1998 Form 10K:
- Failed to disclose millions of dollars of material related-party transactions
- Inflated income, assets, and equity
  - Failed to write down overvalued related-party mortgages and land contracts held for resale
  - Failed to write off uncollectible receivables from related parties
- Unqualified audit opinion was issued

- Falling margins in mortgage banking business
- Needed more cash to finance operations
- Fear of loss of credit lines
- Investors might not invest in MCA debentures if it reported significant losses
MCA Financial Corporation—Schemes

- Purchased distressed properties in Detroit and sold them to related parties at inflated prices
  - Advanced the down payment
  - Held the mortgage
  - Recognized the gain
- BUT!! The related parties could not afford to make the payments
MCA Financial Corporation—Schemes

- Inadequate allowances for loan losses recorded
- Did not disclose identity of the related-party transactions in its financial statements
- Double pledged the same real estate to support added borrowings
MCA Financial Corporation—Schemes

- “Remetering”—the same debtors executed new mortgages and land contracts to replace the old, unpaid ones
- Purpose?? Disguise the age of the loans
$39.8 million of its $102.2 million mortgages held for resale were related parties

$6.7 million of its $20.7 million in land contracts held for resale were with related parties
MCA Financial Corporation—Audit Failures

- Detected or otherwise became aware of illegal acts but did not report them to the Board (aided and abetted the fraud)
- Did not adequately plan audit tests for mortgage valuations
- Did not obtain sufficient competent evidential matter
- Did not maintain an attitude of skepticism after becoming aware of RED FLAGS

Result? Disgorgement of audit fee ($59,749.71), pay $1.5 million fine, $1 million funding for fraud detection training for employees
MCA Financial Corporation—Audit Failures

- Audit risk was assessed as “high” on the Fraud Assessment Form
  - Significant and/or frequently difficult to audit transactions and “material” related-party transactions on a recurring basis
  - “Significant estimates involving unusually subjective judgments or uncertainties . . . ? YES
  - “Significant related-party transactions not in the ordinary course of business?” YES
  - “Highly complex transactions?” YES
MCA Financial Corporation—Audit Failures

- 82% of pre-tax income was from sale of real estate to related parties (1998)
- Significant 1996 and 1997 losses if you exclude the related-party sales
- Carrying value of mortgages receivable rose 88% and 100% for 1997 and 1998.
- Taking longer to sell the loans to outsiders
- 46 of 128 mortgages held for resale and selected for testing were over 90 days old (21 were over 180 days old)
  - MCA annual report said they were typically sold in 45 to 60 days
MCA Financial Corporation—Audit Failures

- Audit program labeled as “Not Applicable” several critical audit procedures on the mortgages
- Auditors learned that the related parties were projecting negative cash flow (How could they repay the debt?)
- AUDITOR LIQUIDATION ANALYSIS:
  - Relied on management’s estimate of the fair market values of the properties supporting the mortgages receivable
  - Relied on an appraiser who was the brother-in-law of MCA’s CEO
- Did not challenge lack of disclosure of related-party issues
Detecting Inadequate Disclosure Fraud

Detecting disclosure fraud is not as easy as detecting the other types of fraud discussed in this course. In fact, without a tip or complaint, it is difficult to know that disclosure fraud is occurring.

It is usually easier to detect disclosure fraud that involves misleading disclosures than it is to detect disclosure fraud that involves missing disclosures.

LOOK FOR SYMPTOMS!!!!
Disclosure Fraud Related to Financial Reports and Financial Statement Footnotes

- Look for inconsistencies between disclosures and information in the financial statements and other information you are aware of.
- Make inquiries of management and other personnel concerning related-party transactions, contingent liabilities, and contractual obligations:
  - Should be made at several levels of management
  - Should be done separately and judiciously
Disclosure Fraud Related to Financial Reports and Financial Statement Footnotes

- Make inquiries about different accounting policies that management is aware of.
- Review the company’s files and records with the SEC and other regulatory agencies concerning names of officers and directors who occupy management or directorship positions in other companies.
Red Flags for Inadequate Disclosures

- Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls

- Ineffective board of directors or audit committee oversight over the financial reporting process and internal control
Red Flags for Inadequate Disclosures

- Ineffective communication, implementation, support, or enforcement of the entity’s values or ethical standards by management or the communication of inappropriate values or ethical standards
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
Red Flags for Inadequate Disclosures

- Significant, unusual, or highly complex transactions, especially those close to period-end that pose difficult “substance over form” questions
- Significant related-party transactions not in the ordinary course of business, or with related entities not audited or audited by another firm
Red Flags for Inadequate Disclosures

- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
Red Flags for Inadequate Disclosures

- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
Red Flags for Inadequate Disclosures

- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality
Red Flags for Inadequate Disclosures

- Formal or informal restrictions on the auditor that inappropriately limit access to people or information, or the ability to communicate effectively with the board of directors or audit committee