Fraudulent Financial Reporting

Course #1003

Auditing

2 Credit Hours

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FRAUDULENT FINANCIAL REPORTING (COURSE #1001A)

COURSE DESCRIPTION

"Management fraud" and "fraudulent financial reporting" are synonymous. In general, financial statement fraud occurs through: (1) the overstatement of assets and income, and (2) the understatement of liabilities and expenses. Since the production of financial statements is the responsibility of management, financial statement fraud almost always occurs with the knowledge or consent of management. This short course deals with the different schemes associated with management fraud. Uses material entitled Management Fraud adapted from *Managers & Auditors Fraud Examination*.

PLEASE NOTE: This course material is a component of #1001A, *Managers & Auditors Fraud Examination*, and therefore we recommend that you should not take both courses in the same CPE reporting period.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

ASSIGNMENT **SUBJECT**

1 **Management Fraud**

Study the course materials from pages 1 to 40

Complete the review questions at the end of the course

Answer the exam questions 1 to 10

Objectives:

- To recognize management fraud techniques as they relate to misstated financial statements

ASSIGNMENT **SUBJECT**

2 **Complete the Online Exam**

NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course (#1001A) qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

ENJOY YOUR COURSE

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MANAGEMENT FRAUD

Course Objective

After completing this course, you should be able to:

- Recognize management fraud techniques as they relate to misstated financial statements.

The terms “management fraud” and “fraudulent financial reporting” are synonymous. The production of financial statements is the responsibility of management. Therefore, financial statement fraud almost always occurs with the knowledge or consent of management. Victims can be persons either inside or outside the company. Insiders who are possible victims include directors, managers, and employees who may suffer a loss of position, reputation or standing. Outside victims include investors, creditors, depositors, suppliers, customers, partners, underwriters, attorneys, and independent auditors.

Financial Statement (Management) Fraud Defined

According to Elliott and Willingham, financial statement fraud is management fraud:

> “The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.”

The responsibility for detecting management fraud largely has fallen to the accounting profession. Since the early 1970’s, this responsibility has gradually increased. Standards for independent auditors are set forth in Statements on Auditing Standards issued by the Auditing Standards Board of the American Institute of CPAs. These auditing standards deal almost exclusively with the problem of materially misleading financial statements (the organizational crime of management fraud) and very little with embezzlement and larceny (the occupational crime of employee fraud).

Why Financial Statement Fraud Is Committed

False financial statements are used to make a company’s earnings look better on paper. False statements sometimes cover up the embezzlement of company funds. Financial statement fraud occurs through a variety of methods, such as valuation judgments and fine points of timing the recording of transactions. These more subtle types of fraud are often dismissed as either mistakes or errors in judgment and estimation. Some of the more common reasons why people commit financial statement fraud include:

- To encourage investment through the sale of stock
- To demonstrate increased earnings per share or partnership profit interests, thus allowing increased dividend and distribution payouts
- To dispel negative market perceptions
- To obtain financing, or to obtain more favorable terms on existing financing

- To receive higher purchase prices for acquisitions
- To demonstrate compliance with financing covenants
- To meet company goals and objectives
- To receive performance-related bonuses

This limited list of reasons shows that the motivation for financial fraud does not always involve personal gain to the managers. The cause of fraudulent financial reporting is the combination of situational pressures on either the company or the manager(s) and the opportunity to commit the fraud without the perception of being detected. These pressures are known as “red flags.” If red flags indicating situational pressures and opportunity are present, the risk of financial reporting fraud increases significantly.

Examples of situational pressures include:

- Sudden decreases in revenue or market share experienced by a company or an industry
- Unrealistic budget pressures, particularly for short-term results
- Financial pressures resulting from bonus plans that depend on short-term economic performance

Opportunities to commit fraud generally arise from the lack of adequate oversight functions within the company. However, the existence of an oversight function does not, in and of itself, guarantee the detection of management fraud. The oversight functions must also respond effectively. The perception of detection is arguably the strongest deterrent to fraud. Some of the more obvious opportunities for management fraud are:

- The absence of, or improper oversight by, the board of directors or audit committee; or, the neglectful behavior of the board or committee
- Weak or non-existent internal controls, including an ineffective internal audit staff and a lack of external audits
- Unusual or complex transactions
- Financial estimates that require significant subjective judgment by management.

Financial Statement Schemes

In general, financial statement fraud occurs through (1) the overstatement of assets and income, and (2) the understatement of liabilities and expenses. Misleading statements can also be caused by (3) false or omitted disclosures in notes to financial statements. These misstatements produce higher earnings or partnership profit interests or a more stable picture of the company’s true situation.

To demonstrate these over/understatements, the typical schemes can be put in nine categories. Because the maintenance of financial records involves a double-entry system, fraudulent accounting entries always affect at least two accounts and, therefore, at least two categories on the financial statements. While the nine areas described below reflect their financial statement classifications, keep in mind that the other side of the fraudulent transaction exists elsewhere. It is common for schemes to involve a combination of several methods. The nine general classifications are:

1. Improper revenue recognition–form over substance
2. Revenue recognition in the wrong period
3. Improper sales accounting
4. Improper percentage-of-completion accounting
5. Inadequate disclosure of related party transactions
6. Improper asset valuation
7. Improper deferral of costs and expenses
8. Inadequacies or omissions in disclosures
9. Omission of expenses, losses, and related liabilities

IMPROPER REVENUE RECOGNITION

Improper revenue recognition—form over substance—involves sham transactions made to enhance the reported income or per share earnings. A common scheme in this area is less-than-arm's-length transactions. These transactions will falsely enhance the ordinary earnings of a company. This scheme can occur in a single year or over several years.

Less-Than-Arm's-Length Transactions

These transactions can be particularly difficult to detect because they generally require a co-conspirator's participation. Potential co-conspirators can be inside or outside the company, an affiliated or non-affiliated company, or a related or non-related party. Generally, the co-conspirators receive some benefit from the less-than-arm's-length transaction.

Example of Disclosure Deficiency for Insider Benefit

Informix Corporation was in the business of developing and selling office automation and database software. Informix merged with Innovative Software ("Innovative") whereby Innovative became a wholly-owned subsidiary of Informix. In their complaint, Klein v. King, (D.C. Northern California, No. C 88 3141), the plaintiffs alleged that the officers and directors failed to disclose material adverse facts regarding the company's business operations, both prior to and following the merger, and that it failed to make full, complete and timely disclosure of problems affecting its management earnings, sales, marketing, product development, and financial controls. These non-disclosures adversely affected the potential success of the merger. As a result of the allegedly false and misleading statements prior to the merger, Informix common stock traded at artificially inflated prices.

The purpose of the inflated prices, as alleged, was to enable the officers and directors of Informix to sell substantial holdings (1.8 million shares) for proceeds in excess of $36 million and allow the merger to be accomplished. The plaintiffs further allege that subsequent to the merger, the two companies had difficulty integrating their operations, and management delays occurred in releasing new software programs.

REVENUE RECOGNITION IN WRONG PERIOD

Revenue recognition in improper periods typically involves (1) early booking, (2) holding the books open, and (3) untimely accounting for discounts and returns.

Early Revenue Recognition

Generally accepted accounting principles state that revenue should be recognized when the transaction is essentially complete. In the case of sales, the proper date is the one on which the risks and rewards of ownership pass to the purchaser.

The risks and rewards include possession of an unrestricted right to the use of the property, title, assumption of liabilities, transferability of ownership, insurance coverage, and risk of loss.

In the case of services, revenue should be recognized when the services have been completed and the seller has incurred substantially all the costs. A buyer's acceptance of services rendered is not a requirement, unless the acceptance is a condition of the services themselves which would lead to the argument that the services are not "essentially complete." Therefore, a dispute regarding the quality of services, which arises after the services have been rendered, does not preclude the revenue recognition. However, a dispute may cause the recognition of a liability or reserve against the revenue.

Example of Early Revenue

Time Energy Systems, Inc. developed, promoted and marketed energy conservation systems–hardware and software for managing energy use in buildings. The company, in its capacity as general partner, formed limited partnerships to raise capital for its operations. The limited partnership interests were sold with the idea of using the funds to purchase equipment from Time Energy (the corporate general partner). However, Time Energy supposedly needed to show profitable operations for two reasons:

(1) to induce investment in the limited partnerships, and

(2) to obtain bank financing.

Since the limited partnerships were Time Energy's primary customers, the company had few other sales to show for its profitability. Therefore, Time Energy charged management and incentive fees from research and development contracts to the limited partnerships, presumably for services rendered. Time Energy, however, recognized the fee income before performing the services and also failed to recognize an accrual for future costs of providing the services.

In addition, the limited partnerships borrowed money from outside lenders (banks) and from two of the officers of Time Energy. The borrowed funds were used to pay the management and incentive fees to Time Energy acting as the general partner. When limited partnership interests were purchased, the proceeds of those sales were used to repay the loans to both the banks and to the two officers. Therefore, Time Energy created income for itself through prepaid management and incentive fees (for services not yet rendered), using borrowed money which was later repaid by limited partners' capital contributions.

The SEC filed an enforcement action against both Time Energy and its accountants. The SEC said income was overstated because sales and fee revenues were recognized early, expenses were not accrued, and related-party transactions with the partnerships were not disclosed properly.

Source: Securities Exchange Commission, SEC v. Time Energy Systems, Inc., et al., Civil Action No. 86 1370 (D.D.C.), Litigation Rel. No. 11106, Accounting and Auditing Enforcement Rel. No. 99

Early Booking

Early booking of revenue can take several forms. A company may record anticipated sales and create invoices for the sales. Sometimes the schemes can be very sophisticated, as in the Electro-Catheter Corp. case.

Example of Early Booking

Electro-Catheter Corp. at one time had a normal accounting policy of recognizing sales revenue when merchandise was shipped. At the time the sale was recognized, the customer was billed, and inventory was relieved. The Company changed its policy and began recording sales and cost of sales when customers placed orders. For a two-year period, the Company allegedly overstated its income by approximately $4.5 million as a result of this new policy.

The company's policy was supposedly a "bill and hold scheme," whereby the Company recognized income in periods earlier than warranted. Sometimes the "bill and hold" policy was executed upon receipt of a distributor's order for a dollar amount of goods prior to the distributor identifying which merchandise was to be shipped. (Consequently, it was impossible to relieve inventory because the type of merchandise was not yet identified.) In some cases, shipment did not occur for over one year after the revenue was recognized.

Electro-Catheter Corp. had not passed any of the merchandise ownership rights after the institution of the new "bill and hold" policy. The company retained title to the merchandise, even commingling the goods with other inventory and allowing the customers the right of exchange. Electro-Catheter bore the storage and insurance expenses associated with the merchandise. The company maintained all the risk with respect to the decline in market value because the customers had merely identified a dollar amount and not the specific product mix in their orders.

Source: Securities Exchange Commission, Electro-Catheter Corp., Robert I. Bernstein and John J. Teryilan, Civil Action No. 87 0267 [NHJ] (D.D.C.), Litigation Rel. No. 11803, Accounting and Auditing Enforcement Rel. No. 196

Holding the Books Open

Holding the books open occurs when sales made after the end of the accounting period are nevertheless recorded in the accounting period. In some cases, the sales are real; in others they are fabricated. In service industries, the services may be performed in the next period, or not at all.

Untimely Accounting for Discounts and Returns

Indirect methods can be used to overstate net sales. These methods do not involve the overstatement of gross sales, but instead an understatement in the accounts which reduce gross sales to net sales. For example, an understatement of discounts, returns, and allowances will artificially inflate net sales. The two basic schemes involve failing to mark down discounts on merchandise when sales are made and failing to record returns.

Example of Untimely Discounts

Endo-Lase Company competed well in the market for scientific products by offering discounts and credits to its customers. However, the company allegedly billed customers at list prices, taking off the discounts and credits when the customers paid the net amount due. No estimates of credits and allowances were booked prior to collection. Thus, receivables and sales were overstated until the receivables were collected. As business expanded, so did the overstatement.

Source: SEC v. Michael Clinger, Walter G. Solomon and Avi Oren, Accounting and Auditing Enforcement Rel. No 142

IMPROPER SALES ACCOUNTING

Classifying certain transactions as sales can take a wide variety of forms, from fictitious sales to booking loan proceeds as income. Any increase (credit) to sales can come from a legitimate as well as a non-legitimate source. Schemes involving the improper treatment of sales are designed to overstate or inflate sales.

Fictitious Sales

Fictitious sales most often involve fake or phantom customers. However, fictitious sales can involve legitimate customers. For example, an invoice can be prepared for a legitimate customer with no shipment of goods. At the beginning of the next accounting period, the sale can be reversed. This is a fictitious sale coupled with a spurious bill and hold scheme. Another method of utilizing legitimate customers is to artificially inflate or alter an invoice to reflect higher prices or quantities.

Example of Fictitious Sales

The SEC filed a complaint against the Network Control Corporation for allegedly engaging in improper revenue recognition practices which led to the material understatement of losses reported in Network's first three quarterly Form 10-Qs. According to the complaint, the company employed fraudulent practices consisting of: (1) recording transactions as sales when customers had not agreed to purchase the equipment and the equipment had not been delivered; (2) recording a sales "prospect list" as sales transactions; and (3) removing inventory from Network's premises to simulate the delivery of goods sold to the customers, when no such delivery had occurred.

In the related class action lawsuit, the plaintiffs alleged that Network arbitrarily shipped unordered goods to potential customers, falsely recorded sales revenue from these shipments, and lost money when Network was either forced to accept the return of the

Example of Fictitious Sales (continued)

unordered goods or to convince customers to keep excess shipments by providing substantial discounts and other costly incentives.

Source: Smith v. Network Equipment Technologies, Inc. et al., D.C. Northern District of California No. c-90-1138

As seen in the Network Control example, sales overstatement schemes can employ two or more schemes simultaneously to overstate sales. In this example, the company used fictitious sales, early recognition of revenue, and holding the books open. The company did not stop there. In addition to the three schemes, the company also entered into some fictitious related-party transactions which, when discovered, resulted in the revenue overstatement by an additional $240,500 and an asset overstatement of $184,000.

Example of Fictitious Sales

The SEC filed a civil action against Coated Sales, Inc., alleging that pursuant to a plan formulated by the former Chairman and CEO of the company, officers and employees of Coated engaged in a scheme to inflate accounts receivable and inventory. The complaint alleged that the employees and directors engaged in schemes designed to: (1) create phony invoices purporting to show sales of Coated; (2) record the phony invoices in the accounts receivable of Coated; and (3) in order to create the appearance that the phony invoices were being paid, apply proceeds from the sale of common stock.

Phillip K., former general counsel, assistant secretary, and director of Coated Sales, Inc., admitted to racketeering and securities fraud charges. He was the last of several officers to plead guilty to crimes contributing to Coated Sales' failure.

Coated Sales was one of the nation's fastest growing companies before it collapsed, robbing stockholders of more than $100 million and several banks of $52 million. Philip K. admitted he was paid $115,000 for legal work done for Coated Sales. He conspired with company executives to omit the payment from the company's annual report filed with the SEC.

Philip K. and other executives tried to persuade the company's external auditor to falsely state in an annual report that $6 million was used to buy machinery. The $6 million had been listed on bogus accounts receivable invoices, which were later used as collateral for about $52 million in bank loans.

When the external accountant resigned the Coated Sales account, the company's stock plummeted, and Coated Sales declared bankruptcy one month later.

Source: The Associated Press; Byline: Dwight Oestricher, Associated Press Writer.

Sales With Conditions

Sales with conditions are sales that have not been completed and the risks and rewards of ownership have not passed to the purchaser. These types of sales are similar to schemes involving the recognition of revenue in improper periods, in particular the early recognition of revenue.

Example of Sales with Conditions

Automatix, Inc. sold products that required engineering and adapting work before they were acceptable to customers. However, the company recorded sales revenue before completing the engineering, testing, evaluation, and customer acceptance stages of production. In some cases, sales were to European subsidiaries and the final sales to user-customers did not takeplace for weeks or months. In other cases, sales were specifically contingent upon the customers' trial and acceptance of the product. To compound the problem, the company supposedly did not adequately record the progress of each order through the various stages of development, construction, testing, trial, and acceptance.

The amount of the resulting overstatement was undisclosed in the SEC complaint, and the company was ordered to engage the services of an independent accountant to review and report on the procedures with respect to revenue recognition. The company was also ordered to implement any recommendations the independent accountant might make.

Source: Securities Exchange Commission, SEC v. Automatix Inc., Civil Action No. 86-1596 (D.D.C.); SEC v. John Dias, Civil Action No. 86-1597 (D.D.C.), Litigation Rel. No. 11121, Accounting and Auditing Enforcement Rel. No. 100

Example of Sales with Conditions

The SEC filed an enforcement action against Storage Technology Corporation, alleging material false statements and overstated revenues and accounts receivable. Storage Tech was engaged in the design, development, manufacture, marketing, and servicing of computer peripheral subsystems. The complaint alleged that Storage Tech recognized revenue before collection of the sales price was reasonably assured and before completion of the underlying sales transaction.

Storage Tech's policy was to recognize revenue when the products were shipped. However, the sale was not complete as of the time of shipment because: (1) customers were not obligated to pay for the equipment until it had been installed, (2) Storage Tech had substantial obligations to the customers for installation and adjustments, and (3) major uncertainties concerning the customers' true willingness to complete the transaction remained because of the volatile nature of the high-tech product.

Example of Sales with Conditions (continued)

Source: Securities Exchange Commission, SEC v. Storage Technology Corporation, Civil Action No 87-0175, Litigation Rel. No. 11340, Accounting and Auditing Enforcement Rel. No. 125.

Consignment Sales

A consignment sale is not a completed sale with respect to the revenue recognition by the seller, until such time as the ultimate end-user (purchaser) accepts the product. For example, art galleries often accept artwork from artists on consignment. Once the artwork is sold to the gallery patron, the artist recognizes the revenue, but the artist cannot recognize the revenue upon delivery of the artwork to the gallery. Many other products ranging from books to fertilizers are "sold" on consignment.

Example of Consignment Sales

Edgar B., president of the Jacquard Division of AM International, Inc. allegedly "kept open" Jacquard's books routinely at the end of various months to record revenue for products which were shipped in subsequent months. Additionally, Jacquard officials, supposedly with Edgar B's knowledge, were said to have booked revenue upon shipment for sales which were, in substance, consignment sales.

The result of the "open book" scheme was an overstatement of pre-tax income of approximately $500,000 and an overstatement of accounts receivable of approximately $6 million. The "consignment" scheme resulted in an overstatement of pre-tax income of $3 million. Consequently, the periodic reports containing these overstatements were alleged to be materially false and misleading.

Source: Securities Exchange Commission, SEC v. Edgar Bolton, No. 85 Civ. 4787 (JES) (S.D.N.Y.), Litigation Rel. No. 11699, Accounting and Auditing Enforcement Rel. No. 185

IMPROPER PERCENTAGE-OF-COMPLETION ACCOUNTING

The percentage-of-completion method of accounting is a fertile area for financial statement fraud, even though it applies only to certain types of transactions. Percentage-of-completion schemes are often difficult to track because several estimates are involved in the accounting calculation.

Percentage-of-completion was originally designed to account for long-term contracts in the construction industry. The method has been extended to contracts in many other industries, and the concept of "long term" has been shortened to be months instead of years.

Generally accepted accounting principles state that the percentage-of-completion method is preferred when both the costs and the extent of progress toward completion of the long-term contract are reasonably dependable. It is precisely these conditions that give rise to improper revenue recognition under the percentage of completion method. If management cannot make reasonably dependable estimates of a project's completion stage, the percentage-of-completion accounting method is not appropriate. If this method is used inappropriately, the financial statements can be materially misleading.

Misrepresenting Percentage of Completion

Revenue and the related expenses, using the percentage-of-completion method of accounting, are subject to misrepresentation. This commonly occurs when management knows the project is less complete than the amount declared on the financial statements. This scheme, in some instances, occurs with the production of fictitious documents.

Example of Percentage of Completion

George Risk Industries, Inc. ("GRI") designed, manufactured and marketed computer keyboards, push-button switches, and burglar alarm systems. GRI raised capital for its research and development projects by having investors sign contracts or "pledges." These contracts called for capital to be contributed 25% in cash with a promissory note for the balance. The promissory notes did not provide for payment of interest until the principal became due.

The SEC filed a civil action against GRI alleging that the company improperly used the percentage-of-completion method of accounting for its research and development project which caused an overstatement of revenues for three years. Additionally, the SEC alleged that GRI overstated its working capital for the same three years. The complaint alleged that GRI lacked the ability to make reasonably dependable estimates of the stage of the project's completion and it could not be reasonably expected that the investors would fulfill their obligations on the long-term notes.

The alleged material overstatement of working capital was a result of GRI classifying accrued interest receivable on the promissory notes from the investors as a current asset. No payments of interest were made on these notes during the years that this accrued interest was reported as a current asset.

Source: Securities Exchange Commission, SEC v. George Risk Industries, Inc., Civil Action No. 88-2553 (D.D.C.), Litigation Rel. No. 11864, Accounting and Auditing Enforcement Rel. No. 199

Example of Percentage of Completion

Midwestern Companies, Inc. constructed ethanol plants for sale to customers. In its civil action against the company, the SEC alleged that Midwestern's reported revenues, net earnings, assets, and shareholders' equity were materially overstated, reflecting a false trend of increasingly favorable operating results when, in fact, Midwestern's financial condition had severely deteriorated. One of the reasons cited for the deterioration of Midwestern's financial condition was failure of the ethanol plants to operate after they were sold.

In one year, Midwestern reported over $23.2 million in revenues and approximately $9.5 million in pre-tax earnings and $44 million and $20.7 million in revenues and pre-tax earnings, respectively, in the first three quarters of the next year. The SEC alleged that Midwestern should have reported losses, not pre-tax income for these periods. This overstatement of income was the result of Midwestern's improper use of the percentage-of-completion method of accounting. The collection of the sales price for the sale of the ethanol plants was not reasonably assured and Midwestern was obligated to perform significant activities after the purported sale of the plants. Certain of the reported sales had not been consummated. The complaint further alleged that the company formed by Midwestern to purchase the ethanol plants was not independent, but was organized, controlled and financially supported by Midwestern.

The company supposedly manipulated and misrepresented the stage of completion of construction by falsifying some invoices for costs incurred, thus understating the estimated costs to complete. According to the SEC, when a cost-based percentage of completion method was applied to the manipulated data, Midwestern recognized more revenue than the facts warranted, and overstated the construction-in-progress inventory.

Source: SEC v. Ronald R. Walker, et al., Civil Action No. 86-523 (W.D. Mo.), Litigation Rel. No. 11071, Accounting and Auditing Enforcement Rel. No. 96. Litigation Rel. No. 11267

Unsupported Adjustments

Unsupported adjustments occur when management estimates the percentage of completion of a particular project without proper basis or documentation. Although unsupported adjustments can be the cause of fraudulent financial reporting in any area of the financial statements, the percentage-of-completion accounting method is particularly vulnerable because of its dependence on estimates.

INADEQUATE DISCLOSURE OF RELATED-PARTY TRANSACTIONS

The inadequate disclosure of related-party transactions is a serious financial statement fraud. These transactions are susceptible to non-arm's-length manipulation. The Federal Deposit Insurance Corporation ("FDIC"), in an effort to curb some of this type of financial statement fraud, has issued proposed rules aimed at improving detection procedures and preventing losses in connection with fraud and abuse by bank officers and other insiders.

Insider fraud accounts for more than half of all the financial institution fraud and embezzlement cases brought by the FBI, and total losses from these cases reaches several hundred million dollars. Inadequate disclosure of related-party transactions is not limited to any specific industry. It transcends all business types and relationships.

Two of the most common areas of related-party transactions involve conflict of interest and sham transactions.

Conflict of Interest

A conflict of interest occurs when a company official or insider has an undisclosed financial interest in a transaction. The financial interest of the company official is sometimes not immediately clear. For example, common directors of two companies doing business with each other, any corporate general partner and the partnerships with which it does business, any controlling shareholder and the corporation with which he or she does business are all illustrations of related parties. Family members can also be considered related parties. Related-party transactions are sometimes referred to as "self-dealing."

In some cases, the conflict of interest does little serious harm. In other cases, it is used to embezzle company funds. Several of the examples discussed previously have included fraud schemes that were partially a result of conflict of interest. In these, and the examples below, the conflicts of interest are not always easy to detect.

Example of Related-Party Conflict

American Biomaterials Corporation's (ABC) former chief executive officer and former chief financial officer formed a partnership called Kirkwood Associates. This partnership was formed as an executive search firm. ABC allegedly paid Kirkwood in excess of $410,000 for the location of 25 employees. These fees accrued for the benefit of the CEO and CFO of ABC, yet ABC failed to disclose this related-party transaction. Moreover, Kirkwood allegedly did not perform any substantial services in connection with ABC's hiring the 25 employees.

Example of Related-Party Conflict (continued)

In addition to this failure to disclose the related-party transaction, ABC allegedly paid in excess of $65,000 in undisclosed perquisites for the benefit of one executive. These perquisites included: (1) the personal service of a carpenter, (2) personal jewelry, (3) use of the company credit card to purchase over $11,000 of personal items, (4) the use of company funds to purchase over $38,000 in personal items including clothes and furniture, and (5) reimbursement for business meals for which ABC had already paid.

Source: Securities Exchange Commission, American Biomaterials Corporation, Civil Action No. 88-1063 (D.D.C.), Litigation Rel. No. 11710, Accounting and Auditing Enforcement Rel. No. 187

Sham Transactions

Sham transactions are transactions with no economic substance or purpose. They are commonly used to inflate earnings or assets. In some cases, they hide the true nature of a transaction.

Example of Sham Transactions

G.C. Technologies, Inc. (GC) was controlled by Groover (an attorney) through nominee officers, directors, and shareholders. Groover acquired lease interests in producing oil wells located in Kansas at a cost of $63,150. These interests were "purchased" by GC for $180,000 shortly thereafter. About a month later, Groover acquired two mining leases on behalf of another nominee company for $550,000. This nominee company sold a 30% interest in the mining leases to GC for $1.5 million. Neither of these transactions was disclosed by GC as related-party transactions. Furthermore, even though GC purchased only a 30% interest in the two mining leases, it reported the entire, albeit inflated, purchase price of the entire lease interests.

Groover was convicted of using sham transactions and nominee officers, directors, and shareholders to create a misleading financial picture of GC. Groover hid his involvement in companies and caused related party transactions to appear as if they were conducted at arm's length.

Source: United States of America v. Larry B. Groover. United States District Court for the District Court of Utah, Case No. 89-CR-02318. Accounting and Auditing Enforcement Rel. No. 285, Litigation Rel. No. 12724

Example of Related Party Transaction

American Saving and Loan Association of Florida (ASLA) entered into two repurchase transactions involving ESM Government Securities, Inc. (ESM), a broker-dealer in U.S. Government securities. ESM's principal and founder was on ASLA's board of directors. These repurchase agreements were, for all practical purposes, financing vehicles whereby ASLA purchased government securities, sold the government securities to third parties and agreed to repurchase the securities upon their maturities.

These repurchase transactions were substantially larger than any single previous ASLA securities transaction. They increased ASLA's assets and liabilities by approximately 33%. The alleged purpose of the repurchase transactions was to enable ASLA to recognize profit of $5.6 million, represented by the difference between the purchase and the repurchase price.

The creditworthiness of some of the end-lenders in the repurchase transaction came under closer scrutiny by ASLA. This alerted ASLA to the potential risk of the transactions themselves and as a result, ASLA unwound the repurchase agreement transactions prior to their maturity dates. No disclosure was made of the premature unwinding of the transactions, the reasons for the unwinding, or the financial consequences. ASLA also did not disclose the fact that the substantial increase in its assets was essentially due to transactions with an affiliate of an ASLA director.

Source: Securities Exchange Commission, Matter of American Savings and Loan Association of Florida, FHLBB Enforcement Review Committee Resolution No. ERC 88-24; Exchange Act Rel. No. 34-25788, Accounting and Auditing Enforcement Rel. No. 194

IMPROPER ASSET VALUATION

Improper asset valuations involve a host of schemes because they involve estimates. According to SAS 57 (now AU Sec. 342), an accounting estimate is "an approximation of a financial statement element, item or account." Examples of accounting estimates include:

- Net realizable value of accounts receivable
- Allowance for loan losses
- Net realizable value of inventory
- Valuation of securities
- Warranty expense and liability
- Percentage of completion revenue and construction-in-progress inventory

- Deferred revenue
- Probability and amount of contingent losses
- Fair value of non monetary exchanges
- Many others (listed in SAS 57 (AU 342)).

Although management is responsible for making the accounting estimates, auditors are responsible for evaluating the reasonableness of those estimates in the context of the financial statements taken as a whole. In an effort to discharge those responsibilities, external auditors are supposed to:

- Keep track of the differences between management's estimates and the closest reasonable estimates supported by the audit evidence.
- Evaluate the differences taken altogether for indications of systematic bias and the combination of differences with other likely errors in the financial statements.

Most improper asset valuations involve the fraudulent overstatement of inventory and receivables. Other improper asset valuations can be purchase-versus-pooling accounting methods, misclassification of fixed and other assets, or improper capitalization of inventory or start-up costs.

Inventory

Inventory can be improperly valued through the manipulation of the percentage-of-completion accounting method, manipulation of the physical inventory count, failing to relieve inventory for costs of goods sold, and failing to make proper estimates for obsolete and unsalable goods. One of the most popular methods of overstating inventory is through fictitious (phantom) inventory.

Fictitious inventory schemes usually involve the creation of fake documents such as inventory count sheets, receiving reports, and even fake physical goods. In some instances, a friendly co-conspirator claims to be holding inventory for the company in question. Finally, it is also common to insert phony count sheets during the inventory observation or change the quantities on the count sheets.

Example of False Inventory

Former associate chairman of San Francisco-based Hambrecht & Quist (H&Q), Quentin W., was indicted by a federal grand jury for securities fraud and wire fraud. The indictment was for alleged illegal activities, including materially false and misleading financial statements, while he was chairman of Miniscribe Corporation.

H&Q, on behalf of a group of individuals and entities, made a venture capital investment of about $20 million in Miniscribe, gaining control of the company. Miniscribe, which made disk drives, filed for bankruptcy protection. According to an internal investigation report, the company inflated its inventory by packaging bricks as finished products. Scrap parts were also counted as inventory.

Example of False Inventory (continued)

The indictment said Quentin W. and others engaged in an unlawful scheme to defraud by filing materially false and misleading financial statements with the SEC. The indictment said he ordered destroyed a memorandum that showed Miniscribe's reported inventory had a shortfall of millions of dollars.

The indictment also stated that during the period when the inventory was falsely represented, Quentin W. sold 150,000 shares of Miniscribe for about $1.7 million while having non-public information about the inventory shortfall.

Source: Reuters, Limited; Dateline: Denver.

Example of False Inventory

Rocky Mount Undergarment Co., Inc. (RMU) manufactured and marketed women's, men's, and children's underwear. RMU, with its supplier as co-conspirator, allegedly overstated RMU's inventory. The supplier claimed to be holding inventories for RMU. In addition, three employees, allegedly at the direction of the former CEO, inflated quantity and cost figures on the inventory count sheets reflecting the year-end physical count of RMU's raw material inventory. These falsifications resulted in overstating inventory by 9% and net income by 134%.

Source: Rocky Mount Undergarment Co., Inc., et al.., Civil Action No. 89-014-5 (E.D.N.C.), Litigation Rel. No. 11960 Accounting and Auditing Enforcement Rel. No. 212

Inventory Valuation Issues

Inventory should be valued at the lower of cost or market, and obsolete inventory should be written down to its current value, or written off altogether if it has no value. Failing to write-down inventory results in overstated assets and the mismatching of revenues with cost of goods sold.

Example of False Inventory

The former president and chief executive officer and the former vice president of Saxon Industries, Inc. (Saxon) pleaded guilty to conspiracy and securities and mail fraud charges in connection with the falsification of Saxon's financial statements. These and other executives allegedly spent 14 years systematically defrauding shareholders and creditors of Saxon by adding more than $53 million in non-existent inventory to the books of various Saxon subsidiaries and divisions, creating an illusion of increased profits and assets.

Example of False Inventory (continued)

The SEC alleged that the "red flags," including the denial of access to the general ledger and other corporate records, was enough to put the independent auditors on notice that an intensified audit was necessary.

Source: SEC v. Arthur Rogovin and Albert DeBiccari, Civil Action No. 86-1740 (S.D.N.Y.), Litigation Rel. No. 11018

Example of False Inventory

A Long Island auto and motor home dealer with business holdings in Connecticut, Maryland, Florida, Georgia, and Nevada was charged with federal loan kiting charges while awaiting developments in another court case involving seizure of 700 new cars from his dealership.

Federal authorities described John M's get-rich scheme as the largest Ponzi-type kiting scheme ever conducted in the United States. It left General Motors with a $436 million loss.

John M., whose main car dealership was in Port Jefferson, New York, was charged with mail fraud, wire fraud, and money laundering. He defrauded GM by means of a phony auto-exporting scheme involving dummy companies he allegedly set up in Indiana and the island of Cyprus. His scheme went on for 10 years until GMAC auditors made a "routine visit" to his dealership. John M. allegedly borrowed $1.75 billion from GMAC to finance an inventory of tens of thousands of cars that did not exist.

John M's net worth was listed as $338 million. He was ordered by the court to sign over his $500,000 home, private jet, gold mine in Nevada, and the assets of 70 companies and 100 real estate holdings from Connecticut to Florida. In addition, he had to hand over a $200,000 cash bond and turn over his passport.

Reportedly, one of John M's bogus companies, Kay Industries, a van conversion company, was never registered with the U.S. Department of Transportation as required of all vehicle alteration companies. John M. was a major dealer in altered vehicles that are actually custom-made cars and vans built on standard chassis. The federal complaint charged him with using bogus invoices from Kay to obtain 30-day financing from GMAC for purchases of up to 17,000 vans a month.

Source: The New York Times Company/The New York Times; Byline: Jane Fritsch.

Accounts Receivable

Accounts receivable are subject to manipulation in the same manner as sales and inventory. In many cases, the schemes are conducted together. The two most common schemes involving accounts receivable are fictitious receivables and the failure to write down or allow for uncollectible accounts receivable.

Fictitious Accounts Receivable

Fictitious accounts receivable is common among companies with financial problems, as well as with managers who receive a commission based on sales. The typical entry under fictitious accounts receivable is to debit (increase) accounts receivable and credit (increase) sales. These schemes tend to be timed around the end of accounting periods.

Example of Fictitious Sales and Receivables

The now-defunct Deerfield Beach, Florida company, Sahlen & Associates, was once the fifth-largest security service firm in the world, employing nearly 12,000 people at its peak. Sahlen & Associates provided security for President Bush's 1989 inauguration and for the 1988 Democratic and Republican Conventions. It also performed security work for AT&T, Delta Air Lines, Dow Chemical, and IBM. It serviced the DEA and guarded construction sites for 22 U.S. embassies.

Over a five-year period, reported company revenues grew from $459,000 to $54.9 million. The financial records made the company attractive to investors. However, these allegedly falsified records were used to create an "illusion of success." According to one expert, the firm was so broke it had to kite checks to create operating funds. The company even wrote reports to justify fake billings and mailed invoices to fake clients at post office boxes so the outside auditors would find convincing paper trails.

The company had 20 million outstanding shares when it collapsed, after directors announced it was under investigation by the Securities Exchange Commission. The portion of the business untainted by fraud was auctioned for $40 million. Harold S., the company founder, and six others were charged in a 28-count indictment which included conspiracy to defraud the SEC, securities fraud, bank fraud, and mail fraud.

Source: United Press International, 1993: Dateline: Ft. Lauderdale, FL.

Failure to Write Down

Companies should write off uncollectible receivables. The two methods for write-off include the allowance method and the direct charge method. Companies struggling for profits and income will often choose not to write off or allow for bad accounts receivable because of the negative effect on income.

Example of Failure to Write-Down Receivables

Allnet Communication Services, Inc. (Allnet), a publicly held company, was in the long-distance telephone business. Allnet had a problem with its computerized accounts-receivable system. The internal processing system lacked a balance-forward feature on generated bills. This led to an inability of customers to determine whether an unpaid balance existed or whether payments had been properly credited. As a result, Allnet accumulated a backlog of unaddressed or unresolved disputes.

The problems with the billing system led to billing delays which decreased the ultimate collectibility of these accounts. In addition, the system failed to give Allnet's management complete and accurate aging data on accounts receivable.

As a result of the problems with the billing system, the $4 million annual income Allnet reported should have been reduced by a total of approximately $15 million in uncollectible accounts-receivable expense.

Source: In the Matter of Michael P. Richer, Melvyn J. Goodman and Robert S. Hardy, Exchange Act Rel. No. 25528, Accounting and Auditing Enforcement Rel. No. 184

Write-downs are also a consideration in the banking industry. A financial institution's accounts receivable are its loans, the same misrepresentations due to failure to write-down that are available to other companies are available to financial institutions.

Example of Overvalued Loan Receivables

In a class action suit, First American Bank and Trust v. Frogel, et al., (D.C. Southern District of Florida, Case No. 88-0638-CIV-HOEVELER), the plaintiffs alleged that the bank made large loans to present and former officers and directors. Loans were allegedly made in high-risk areas which carried higher interest rates. The bank recorded the loans at full value, but the plaintiffs allege that the bank officers knew that full payment was unlikely. The plaintiffs further allege that the bank failed to report an adequate allowance for loan losses. The FDIC later required the bank to record $50 million of the bank's loans as "loss," "doubtful" or "substandard."

Misclassification of Assets

This scheme is used to inflate the current assets and understate long-term assets. The net effect is to improve the current ratio. The erroneous classification of long-term assets as current assets can be of critical concern to lending institutions that often require the maintenance of certain ratios. This is of particular concern when the loan covenants are on unsecured or under-secured lines of credit and other short-term borrowings. Sometimes these misclassifications are called "window dressing."

Example of False Assets

Two executives of a women's clothing and cosmetics store chain were indicted on charges of looting their company of about $30 million. Victor I., CEO of the Boca Raton, Florida-based Cascade International, and John S., were charged in a 14-count indictment on charges including grand larceny. The charges involved theft of money invested or loaned to the company based on false and inflated claims of its performance made to federal authorities. The alleged fraud was discovered when Victor disappeared.

The company was formed as a shell company in Utah, filed for bankruptcy seven years later, and has since been liquidated. The bankruptcy court found $30 million missing and before it collapsed, investors and creditors may have lost as much as $100 million.

The defendants told federal securities officials that Cascade ran 150 cosmetics counters and 17 cosmetics retail outlets in five states. There were no counters and only one outlet, in Bridgeport, CT. But based on those numbers, Cascade claimed false profits of $3.66 million on sales of $7.76 million. Cascade also claimed it operated 21 women's clothing boutiques in New England, Florida, and California. Reportedly, Cascade ran only five stores–none of them in New England. Based on the alleged bogus filings, Cascade got $10 million in loans from the Bank of Scotland–money that John and Victor allegedly stole.

Source: The Associated Press; Byline: Samuel Maull, AP Writer.

Fixed Assets

Fixed assets are subject to manipulation through several different schemes. Some of the more common are:

- Booking fictitious assets
- Misrepresenting valuations of assets
- Improperly capitalizing inventory and start-up costs

Fictitious Fixed Assets

Fictitious assets can be created by a variety of methods. One of the most common is simply to create fictitious documents. In other instances, the equipment is leased and the fact is not disclosed when the transactions are recorded and reported.

Example of Fictitious Fixed Assets

During a three-year period, several senior officers of Flight Transportation Corporation (FTC) allegedly implemented a scheme to loot FTC through a variety of devices. Some of these devices included reporting non-existent assets, sales of a Cayman Island subsidiary, and undisclosed related-party transactions. The independent auditors gave unqualified opinions on FTC's financial statements.

The SEC found that the audits of these false financial statements had not been conducted in accordance with generally accepted auditing standards in that the auditing work performed provided an insufficient basis to support the unqualified opinions the CPAs issued. The auditors allegedly failed to obtain competent evidential matter to support the existence of reported material assets and the realization of reported revenues. The audits were not conducted with the degree of professional skepticism required of independent accountants.

Source: In the Matter of John E. Harrington and Gregory B. Arnott, Exchange Act Rel. No. 22686, Accounting and Auditing Enforcement Rel. No. 81

Fixed Asset Valuations

Generally, fixed assets should be recorded at the lower of cost or market. According to accounting principles, these assets (property, plant, and equipment) should not be written up to reflect appraisal, market, or current values that exceed cost. Write-up valuations can be of particular concern in mergers and acquisitions and, therefore, subject to much abuse. In some instances, such as the real estate market, the value of property is subject to wide interpretation and valuation. Often, schemes involving the valuation of fixed assets also involve related-party transactions.

Example of Overvalued Fixed Assets

Alta Gold Co. (Alta) was formed in part by the merger of Silver King Mines, Inc. (Silver) and Pacific Silver Corp. (Pacific), who were related parties to each other. Before the merger of these two related parties, Silver and Pacific exchanged mining properties at "fair values" rather than at historical costs. Income and higher asset values were recognized by both Silver and Pacific on the exchange of these properties. The appraisals for the mining properties were performed by three individuals who were officers and directors of Silver and Pacific. Therefore, the appraisals were not prepared by independent parties.

Example of Overvalued Fixed Assets (continued)

The inflated asset values and the false income resulting from the exchange of assets between Silver and Pacific were eventually reported on the financial statements of Alta. Therefore, the financial statements of Alta were materially misstated.

Source: Securities & Exchange Commission, Matter of the Registration Statement of Alta Gold Co., Securities Act Rel. No.6801, Accounting and Auditing Enforcement Rel. No. 203

Improper Capitalization

The two most common areas for improper capitalization are inventory and start-up costs. Inventory is improperly capitalized on some occasions to improve the total assets picture and to hide obsolete inventory. Start-up costs may be improperly capitalized to hide losses.

Example of Improper Capitalization

For two years, U.S. Surgical Corporation (Surgical), a publicly held manufacturer of surgical staples and other medical devices, experienced for the first time sharply increased competition for its products. In an effort to meet these pressures, Surgical allegedly began a frenzied effort to develop, manufacture and market new products, which resulted in large production inefficiencies. Additionally, Surgical changed its accounting policy which resulted in the addition of over $5 million to a patent account which previously had only $1 million, and a 50% decrease in research and development expenditures.

Barden, a supplier of molds and dies to Surgical, conspired to assist Surgical in falsifying its financial statements. Surgical accounted for a large portion of Barden's total revenues (15%). Molds and dies supplied by Barden and used by Surgical in its manufacture of medical supplies were capitalized by Surgical, and parts were inventoried. The parts were eventually expensed through cost of goods sold. Barden allegedly falsified invoices to charge Surgical more for molds and dies and less for parts, thus enabling Surgical to overstate its fixed assets and understate its cost of goods sold. Barden falsified $1 million or more in this manner. A Barden official confirmed false information to Surgical's independent auditors, attesting to the false charges for dies.

Source: In the Matter of Michael S. Hope, et al., Exchange Act Rel., No. 23513, Securities Act Rel. No. 6655, Accounting and Auditing Enforcement Rel. No. 109

Example of Improper Capitalization

Savin, an office equipment manufacturer, was charged with materially overstating its assets and net worth and materially understating its losses by improperly classifying certain costs incurred in the research and development of a new line of photocopiers as “start-up” costs. As a result, Savin allegedly improperly capitalized more than $42 million as an asset.

Source: Securities Exchange Commission, Savin Corporation, Civil Action No. 85-3605 (D.D.C.), Litigation Rel. No. 10928, Accounting And Auditing Enforcement Rel. No. 80

Improper Deferral of Costs and Expenses

Improper deferral of costs and expenses can be difficult to detect. Three common methods for improper deferral of costs and expenses are omissions of liabilities, capitalization of expenses, and failure to accrue enough warranty costs and liabilities.

Omission of Liabilities

Liability omissions can take the form of simple failure to accrue expenses or more complex methods, such as the omission of contingent losses in accounting statements and note disclosures. Liability omissions are probably one of the hardest schemes of fraudulent financial reporting to discover. A thorough review of all post-balance sheet date transactions may go a long way toward discovery that management has omitted liabilities. Also, a review and analysis of all contractual obligations of the company may reveal unrecognized contingent liabilities.

Example of Omitted Liabilities

Because of inadequate internal controls, Marsh & McLennon (Marsh) allegedly allowed $1.2 billion in one year and $2.1 billion in the next year in undisclosed corporate liabilities to accumulate in the form of repurchase agreements. Marsh’s books and records apparently did not accurately reflect the value, nature, terms, and profitability of its investments. Internal controls relating to investment activities were inadequate to ensure that investments were executed in accordance with management’s authorization and that these investments were recorded to permit preparation of accurate financial statements.

Example of Omitted Liabilities (continued)

Total liabilities and total assets were apparently understated, and income before taxes and earnings per share were overstated. Further, disclosures in the financial statements allegedly did not reflect that Marsh held a substantial position in intermediate and long-term marketable securities.

Source: Securities Exchange Commission, In the Matter of Marsh & Mclennan Companies, Inc., Exchange Act Rel. No. 24023, Accounting and Auditing Enforcement Rel. No. 124

Capitalized Expenses

Capitalizing expenses is one of the more common forms of increasing income and assets. Abuses in this category often occur because generally accepted accounting principles are not always clear about rules for capitalizing costs. Financial professionals, fraud examiners and auditors should be diligent when determining the real reason for capitalization. For example, if a company capitalized the purchase of an eighteen-month supply of office supplies, because the supplies would last more than one year, is that an improper capitalization? Or is the company trying to manipulate the income by not reflecting the supplies as a current period expense? Are eighteen months of supplies actually available? Is this material?

Example of Improperly Capitalized Expenses

Computer Science Corporation (CSC) developed and sold computer-related services known as proprietary systems, one of which is known as "Computicket" (CT). Marx, an investor, availed himself of financial data of CSC. That financial data explained CSC's policy regarding capitalizing development expenses.

The policy, in part, stated that CSC would initially capitalize development expenses rather than treat them as charges against current income. When a system (such as CT) became fully operational (defined as generating revenue in excess of expenses), CSC would begin to amortize the capitalized expenses over a specified period of time, presumably over the revenue-generating time period.

At one point, CSC had approximately $6.8 million in capitalized costs for CT. In a registration statement filed with the SEC, CSC stated that it expected to begin amortizing CT's capitalized expenses later.

Example of Improperly Capitalized Expenses (continued)

From its inception, CT had not met internal projections for market capture. CT supposedly experienced problems getting equipment installed, and it had been running deficits of $500,000 per month. In addition, CT lost one of its major contracts. Moreover, CSC had attempted, without success, to sell CT proprietary packages to various prospects for differing amounts. In October and November, CSC had gone so far as to discuss the abandonment of CT. The inference was clear: the likelihood of CT's commercial success became progressively more doubtful with the passage of time.

Marx sued CSC for violations of Rule 10b-5. The court in Marx v. Computer Sciences Corporation, 507 F.2d. 485, stated that the failure to disclose facts indicating that CT was in serious financial trouble was an omission "to state a material fact necessary in order to make the statements made not misleading."

Example of Improper Cost Deferral

Cardillo Travel Systems, Inc. ("Cardillo") installed the Apollo computerized reservation system for United Airlines. In doing so, it incurred costs of $203,000 which, by arrangement, were to be reimbursed by United Airlines. When the reimbursement arrived, it was credited to revenue and the deferred costs were left in the asset account. Under the terms of the arrangement, the deferred costs were in the nature of an account receivable, and the reimbursement should have reduced this receivable and not increased income. Consequently, both assets and revenue were overstated.

Source: Securities Exchange Commission, SEC v. Cardillo Travel Systems, Inc. et al., Accounting and auditing Enforcement Rel. No. 143 (August 4, 1987); Litigation Rel. No. 11675

Warranty Cost and Liability

Warranty expense understatement occurs when a company fails to accrue the proper expense and offsetting liability for returned or repaired products. The liability can be either omitted altogether or can be substantially understated. Another similar area is the liability resulting from defective products (product liability). Two of the most publicized examples of product liabilities are the Dalkon Shield and asbestos problems (Johns-Manville Corp.). The product liability may become so great and indeterminable as to render a company insolvent. For instance, Johns-Manville filed for protection in bankruptcy as a consequence of its asbestos products.

Example of Omitted Product Liability

In a class action suit against Pfizer, Inc. (Pfizer), a research-based company that deals in pharmaceuticals, medical devices, and surgical equipment, the plaintiffs alleged that Pfizer failed to disclose material information concerning the Shiley heart valve. This material information included the results of at least one product liability suit which Pfizer lost. Four years earlier, Pfizer reportedly knew the Shiley heart valve was troublesome, and it took the valve off the market. However, by that time, approximately 60,000 valves had been implanted. As of the date of the complaint, 389 fractures of the valve had been reported and the FDA reported that 248 deaths had been attributed to failed Shiley valves. Moreover, Pfizer maintained that surgery to replace the implanted valves would be more risky than leaving them in. Pfizer did not provide a reserve for this potential product liability.

Source: In re Pfizer, Inc. Securities Litigation, D.C. Southern District of New York No. 90 Civ. 1260

INADEQUACIES IN DISCLOSURES

Management has an obligation to disclose all significant information. If not measured quantitatively in the financial statements, disclosure should appear in the notes to financial statements or in management's discussion and analysis (MD&A). This information cannot be misleading. A general partner has a duty to disclose all material facts to its limited partners when soliciting the limited partner's consent to a partnership action, especially when a conflict of interest exists.

The court in Huddleston v. Herman & MacLean, 650 F.2d. 815 (5th Cir. 1981), held that "to warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." In this case, a prospectus stated that "These securities involve a high degree of risk." The high degree of risk was due to the fact that proceeds from the stock sale were to be used for the construction of an automobile racetrack. However, at the time of the prospectus, management purportedly knew of understated construction costs and that the company's working capital position would not be as favorable as the prospectus reflected.

Management's discussion and analysis must be made with either a genuine belief or on a reasonable basis. If it is made without either a genuine belief or on a reasonable basis, then it is untrue. (See Eisenberg v. Gagnon, 776 F.2d. 770, 3rd Cir. 1985), cert. denied 474 U.S. 946 (1985) and Marx v. Computer Sciences Corp., 507 F.2d. 485 (9th Cir. 1974).) The most ordinary inadequacies in management's discussion and analyses involve one or more of the following: liability omissions, significant events, and management fraud.

Liability Omissions

Typical omissions include the failure to disclose loan covenants or contingent liabilities. As mentioned previously, another method of liability omission is failure to disclose product liability.

Example of Inadequate Disclosure

The Charter Company ("Charter"), a marketer of crude fuel oils, gasoline and related products, allegedly made material misstatements of fact in its annual report. Management's discussion and analysis omitted: (1) Charter's loss of trade credit, (2) a demand made by Charter's banks for new loan covenants as a condition for renewal of its $130 million credit line, which was scheduled to expire shortly after the report was issued, and (3) discussions with Charter's banks involving proposals which, if implemented, could have generated approximately $130 million in cash, but necessitated the sale of certain assets, the suspension of cash dividends, and the close of crude oil refining operations in Houston, Texas. Charter allegedly failed to disclose the effects of these developments on its operations, liquidity, and capital reserves.

Source: Securities Exchange Commission, SEC v. The Charter Co., Civil Action No. 86-713-CIV-J-12 (M.D. FL.), Litigation Rel. No. 11135, Accounting and Auditing Enforcement Rel. No. 104

Example of Inadequate Disclosure

Continental Illinois Corporation (Continental), the holding company of Continental Illinois National Bank and Trust Co. of Chicago, allegedly mischaracterized $425 million of the nearly $1 billion loan loss provision reported in its Form 10-Q. Continental characterized the $425 million as "loss on sale of loans subject to FDIC agreement." However, Continental allegedly did not disclose that the Office of the Comptroller of the Currency, after an examination, had directed Continental to record a $950 million provision for credit loss in the bank's portfolio before the loan sale. The Comptroller of the Currency concluded that splitting the provision and attributing $425 million thereof to the loss on sale was misleading.

Source: Securities Exchange Commission, In the Matter of Continental Illinois Corporation, Exchange Act Rel. No. 24142, Accounting and Auditing Enforcement Rel. No. 128

Significant Events

Examples of significant events include new products or technology having an effect on sales, obsolescence of merchandise or manufacturing methods, lawsuits whose outcome is unknown, and any other significant event, that, if not disclosed, would mislead the financial statement users.

Example of Omitted Disclosure

E.F. Hutton Group, Inc. (Hutton) allegedly developed a cash management system for moving customer funds received by Hutton branch offices through bank accounts maintained at regional offices and to Hutton's corporate bank accounts located in New York City and Los Angeles. The system required the branch offices to calculate the daily net activity in their branch accounts and then to remove from the accounts all funds in excess of the required compensating balances. On certain days, the branches were alleged to have overdrafted their bank accounts to offset excess collected on other days. If, on the day after a branch over-drafted its bank account, insufficient funds were collected from customers to cover the overdraft, or if there was a delay in the check clearing process, the branch was to deposit a "branch reimbursement check" (BRC) in the branch bank account to make up the difference. BRCs were drawn on zero balance checking accounts which were funded at the end of each day.

Certain members of the senior management of Hutton supposedly encouraged greater use of the draw-down procedure, which increased the interest income and reduced the interest expense of Hutton. Net interest income was significant in Hutton's financial statements.

Hutton allegedly failed to disclose in its MD&A that the increased use of the over-drafting practices was a material cause of the significant increase in net interest income. The complaint also alleged that Hutton's MD&A failed to disclose that the reduced use of the bank over-drafting practices the next year was a material cause of the significant decrease in Hutton's net interest income that year.

Source: Securities Exchange Commission, Matter of E.F. Hutton Group, Inc., Exchange Act Rel. No. 25524; Accounting and Auditing Enforcement Rel. No. 183

Example of Omitted Disclosure

Fluid Corporation (Fluid), a business development company, allegedly failed to disclose a material unreported capital impairment condition which existed for about six months. Fluid owned two subsidiaries, Fluid Capital Corporation and Fluid Financial Corporation. Fluid's primary assets were the two wholly-owned subsidiaries, whose primary functions were to provide venture capital to small start-up companies through loans and equity investments. The two subsidiaries obtained their financing through the sale of debentures to the Small Business Administration (SBA). These debentures were subject to specific loan covenants, one of which was a capital impairment requirement. A capital impairment was deemed to exist when the undistributed-net-retained-earnings deficit exceeded 50% of private capital.

Example of Omitted Disclosure (continued)

The SBA notified Fluid that a capital impairment condition existed at Fluid Capital Corporation. The condition would require a capital addition of at least $200,000. To cure the capital impairment condition, Fluid sold assets of Fluid Capital. The consolidated financial statements of Fluid allegedly failed to disclose that the original audit opinion on Fluid Capital's financial statements was qualified, but later reissued to reflect that no capital impairment existed.

A later report supposedly failed to disclose the SBA's written demand for payment of $1.9 million in debentures issued by Fluid Capital. This report failed to disclose that Fluid's, Fluid Capital's, and Fluid Financial's inability to meet this demand might result in the liquidation or receivership of the companies.

Source: Securities Exchange Commission, In the Matter of Fluid Corporation, Order Instituting Proceedings Pursuant to Section 12(j) of the Securities Exchange Act of 1934 and Section 54(c) of the Investment company Act of 1940, Findings, and Order of the Commission, Accounting and Auditing Enforcement Rel. No. 276, Investment Company Act Rel. No. IC-17756, Admin. Proc. File No. 307394.

Management Fraud

Management has an obligation to disclose to the shareholders significant fraud committed by officers, executives, and others in important positions of trust. According to the court in Roeder v. Alpha Industries, Inc., 814 F.2d. 22, (1st Cir. 1987), management does not have the responsibility to disclose uncharged criminal conduct of its officers and executives. However, if and when officers, executives, or other persons in trusted positions become subjects of a criminal indictment, disclosure is required. In Roeder, the officers of the company bribed a defense contractor employee to obtain a subcontract. When the company learned that its officers were about to be indicted, the company released the information to the public. The court held that no liability can be imposed if there is no duty to disclose. The mere possession of non-public information also does not impose a duty to disclose; there must also be misrepresentation or misleading information as a result of the non-public information. See Backman v. Polaroid Corporation, 910 F.2d 10 (1st Cir. 1990).

Example of False Disclosure

Allegheny International, Inc. (AI) allegedly provided false and misleading information in its MD&A relating to a sale of real estate that constituted an unusual and infrequent event and which had a material impact on AI's pre-tax income.

Example of False Disclosure (continued)

Further, AI allegedly failed to maintain adequate records concerning the personal use of the corporate aircraft, the use of a condominium owned by AI but apparently used by the CEO and his family, a London townhouse purchased for the exclusive use of an AI subsidiary, use of 200 cases of wine purchased by AI for approximately $113,000, and resources devoted by AI to the structuring and administration of certain partnerships formed by AI officers for personal investment purposes.

Source: Securities Exchange Commission, SEC v. Allegheny International, Inc., Civil Action No. 87 2472, Litigation Rel. No. 11533, Accounting and Auditing Enforcement Rel. No. 151

Example of Omitted Disclosure

Wilfred Educational Corporation (Wilfred) owned and operated many "career" schools throughout the United States. Wilfred was a publicly traded company with over nine million shares outstanding. About 95% of Wilfred's students receive some form of government-sponsored financial aid and between 85% and 90% of Wilfred's revenues came from such aid.

In its complaint, the SEC alleged that Wilfred failed to disclose material facts regarding its compliance with the various governmental-sponsored financial aid programs. Allegedly, Wilfred flagrantly violated the regulations by encouraging students to submit false applications. The Department of Justice and the Education Department began investigations into the conduct of Wilfred. These investigations were not disclosed to the public through Wilfred's Annual Report or its press releases.

Source: Ballan v. Wilfred American Educational Corp.

Other Disclosures

The total mix of information made available to the public must meet all the disclosure requirements for adequacy, accuracy, and inclusion. This means that disclosure requirements also apply to press releases and even oral statements.

Example of Misleading Press Release

The court in Columbia Securities v. Sony Corporation, District Court (Southern District of New York, 89 Civ 6821) held that Sony's press release was misleading when it falsely denied that merger negotiations were taking place. During the spring and summer 1989, Sony reportedly made statements to the press which falsely denied that merger negotiations were taking place, when in fact, several merger meetings had been held.

Example of Misleading Oral Disclosure

The primary assets of MHF and Mid-America Partnership consisted of livestock. Mid-America and several other investors purchased interests in the newly-formed partnership based on a multiple of the book value of the livestock, primarily horses. MHF management represented at the offering that the livestock was worth "substantially" more than the $1.6 million book value on the partnership books. In August, Mid-America sold substantially all of the partnership's livestock at auction for $750,000 (net). The partnership sustained a loss in excess of $710,000. The court held that the management of MHF had recklessly misrepresented the livestock's value in discussions at the offering.

Source: Kelly, et al. v. Mid-America Racing Stables, Inc. et al., D.C Oklahoma Western District No. 89-1362-A

TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the course (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this course (assignment).

1.	**Victims of financial statement fraud can be persons both inside and outside the company.** **A.** true **B.** false
2.	**What is the strongest deterrent of fraud:** **A.** a written policy and procedures manual **B.** the perception of detection **C.** a flattened organization chart **D.** decentralization
3.	**Less-than-arm's-length transactions are usually easy to detect because they generally involve only one individual.** **A.** true **B.** false
4.	**What is recording anticipated sales and creating invoices for those sales resulting in revenue recognition in improper periods known as:** **A.** holding the books open **B.** early booking **C.** untimely accounting for discounts and returns **D.** none of the above

5.	**Which of the following is true regarding fictitious sales:** **A.** they most often involve fake or phantom customers **B.** they can involve legitimate customers **C.** they are designed to overstate or inflate sales **D.** all of the above
6.	**A consignment sale is completed with respect to revenue recognition by the seller when the product is delivered to the consignee.** **A.** true **B.** false
7.	**Improper asset valuations involve estimates.** **A.** true **B.** false
8.	**Failure to write-down inventory results in which of the following:** **A.** overstated assets **B.** the mismatching of revenues with cost of goods sold **C.** both A and B above **D.** none of the above
9.	**Companies struggling for profits will quickly write-down uncollectible receivables.** **A.** true **B.** false
10.	**Which of the following is not a scheme for manipulating fixed assets:** **A.** booking fictitious assets **B.** misrepresenting valuations of assets **C.** improperly capitalizing inventory and start-up costs **D.** depreciating assets quarterly

11.	**Which of the following is true regarding the disclosure of management fraud:**
	A. it is management's responsibility to disclose to the shareholders significant fraud committed by officers, executives, and others in important positions of trust **B.** management is responsible for disclosing uncharged criminal conduct of its officers and executives **C.** the mere possession of non-public information imposes a duty to disclose **D.** all of the above

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SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. Potential insider victims include directors, managers, and employees who may suffer a loss of position, reputation, or standing. **B.** Incorrect. Potential outside victims include investors, creditors, depositors, suppliers, customers, partners, underwriters, attorneys, and independent auditors. *(See page 1 of the course material.)*
2.	**A.** Incorrect. Although a company should maintain a policy and procedures manual, this is not the correct answer. **B.** CORRECT. An oversight function must respond to fraud effectively for it to reduce the attempts of fraud. **C.** Incorrect. A flattened organization chart is not the best way to deter fraud. **D.** Incorrect. Decentralization is not the best way to deter fraud. *(See page 2 of the course material.)*
3.	**A.** Incorrect. Less-than-arm's length transactions can be particularly difficult to detect because they generally require a co-conspirator's participation. The co-conspirator will typically receive some benefit from the transaction and can be inside or outside the company, an affiliated or non-affiliated company, or a related or non-related-party. **B.** CORRECT. These transactions actually can be particularly difficult to detect because they generally require participation from a co-conspirator who will receive some benefit from the transaction. *(See page 3 of the course material.)*
4.	**A.** Incorrect. Holding the books open occurs when sales made after the end of the accounting period are nevertheless recorded in the accounting period. **B.** CORRECT. Early booking of revenue can take several forms. **C.** Incorrect. These methods involve an understatement in the accounts which reduce gross sales to net sales. **D.** Incorrect. One of the answers is a correct answer, and therefore none of the above is not correct. *(See page 5 of the course material.)*

5.	**A.** Incorrect. This is true, however, they can also involve legitimate customers. Therefore, this is not the best answer. **B.** Incorrect. For example, an invoice can be prepared for a legitimate customer with no shipment of goods. Then, at the beginning of the next accounting period, the sale can be reversed. However, this is not the best answer. **C.** Incorrect. Schemes involving the improper treatment of sales are designed to overstate or inflate sales, however, this is not the best answer. **D.** CORRECT. All of the responses are true regarding fictitious sales. *(See page 7 of the course material.)*
6.	**A.** Incorrect. Many types of products ranging from books to fertilizers are sold on consignment. Revenue recognition does not occur when the product is delivered to the consignee, but when it is ultimately sold to the end-user. **B.** CORRECT. In a consignment sale, the revenue should not be recognized until such time as the ultimate end-user (purchaser) accepts the product. *(See page 10 of the course material.)*
7.	**A.** CORRECT. An accounting estimate is an approximation of a financial statement element, item, or account. **B.** Incorrect. Improper asset valuations involve a host of schemes, most of which involve the fraudulent overstatement of inventory and receivables. *(See page 15 of the course material.)*
8.	**A.** Incorrect. This is one effect of not writing down inventory, but this is not the only correct answer. **B.** Incorrect. Mismatching of revenues with cost of goods sold is a result of not writing down inventory, but this is not the only correct answer. **C.** CORRECT. Both overstated assets and mismatching of revenues with cost of goods sold are both results that occur when inventory is not written down. **D.** Incorrect. There is an answer that is correct, so none of the above cannot be correct. *(See page 17 of the course material.)*
9.	**A.** Incorrect. Companies should write off uncollectible receivables, but will often choose not to if they are struggling for profits because of the negative effect on income. **B.** CORRECT. Companies struggling for profits and income will choose not to write off or allow for bad accounts receivable because of the negative effect on income. *(See page 19 of the course material.)*

10.	**A.** Incorrect. Booking fictitious assets is a common manipulation scheme of fixed assets. Fictitious assets can be created by a variety of methods. **B.** Incorrect. Misrepresenting valuations of assets is a common manipulation scheme of fixed assets. Fixed assets generally should be recorded at the lower of cost or market. **C.** Incorrect. Improperly capitalizing inventory and start-up costs that should be expensed is a common manipulation scheme. **D.** CORRECT. Depreciating fixed assets on a quarterly basis is generally an acceptable accounting practice because it matches expenses with revenues. *(See page 21 of the course material.)*
11.	**A.** CORRECT. If and when officers, executives, or other persons in trusted positions become subjects of a criminal indictment, disclosure is required. **B.** Incorrect. If and when officers, executives, or other persons in trusted positions become subjects of a criminal indictments, disclosure is required. **C.** Incorrect. The mere possession of non-public information does not impose a duty to disclose; there must also be misrepresentation or misleading information as a result of the non-public information. **D.** Incorrect. Since only one of the responses is correct, all of the above cannot be the correct answer. *(See page 30 of the course material.)*

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GLOSSARY

Conflict of interest: Occurs when a company official or insider has an undisclosed financial interest in a transaction.

Fictitious sales: Often used to artificially inflate or overstate sales.

Financial statement (management) fraud: The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.

Fraudulent financial reporting: Intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements.

Improper revenue recognition: Involves sham transactions made to enhance the reported income or per-share earnings.

Misclassification of assets: Scheme used to inflate the current assets and understate long-term assets.

Percentage-of-completion accounting method: Originally designed to account for long-term contracts in the construction industry. The method has been extended to contracts in many other industries. This is an area that is fertile for financial statement fraud.

Revenue recognition in wrong period: Typically involves (1) early booking, (2) holding the books open, and (3) untimely accounting for discounts and returns.

Sham transactions: Transactions with no economic substance or purpose, commonly used to inflate earnings or assets.

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FRAUDULENT FINANCIAL REPORTING (COURSE #1003A) – FINAL EXAM

The following exam will not be graded. It is attached only for your convenience while you read the course text. To access the exam to be submitted for grading, go to your account and select Take Exam.

1. **Which of the following is <u>not</u> a reason why people commit financial statement fraud:**
   - **A.** to encourage investment through the sale of stock
   - **B.** to receive lower purchase prices for acquisitions
   - **C.** to receive performance-related bonuses
   - **D.** to meet company goals and objectives

2. **In general, financial statement fraud occurs through which of the following:**
   - **A.** the overstatement of assets and income
   - **B.** the understatement of liabilities and expenses
   - **C.** false or omitted disclosures in notes to financial statements
   - **D.** all of the above

3. **Co-conspirators in a "less-than arm's length transaction" can be which of the following:**
   - **A.** inside or outside the company
   - **B.** an affiliated or non-affiliated company
   - **C.** a related or non-related party
   - **D.** all of the above

4. **What is the financial statement scheme which typically involves: 1) early booking, 2) holding the books open, and 3) untimely accounting for discounts and returns known as:**
   - **A.** improper sales accounting
   - **B.** improper deferral of costs and expenses
   - **C.** revenue recognition in the wrong period
   - **D.** improper percentage-of-completion accounting

5. **Which of the following is correct regarding improper sales accounting:**
   - **A.** fictitious sales can involve legitimate and/or phantom customers
   - **B.** such schemes are designed to understate or decrease reported sales
   - **C.** a consignment sale is considered complete with respect to the revenue recognition immediately upon agreement
   - **D.** it is acceptable to post sales made with "conditions" when made instead of when ownership passes to the purchaser

6. **Which of the following is correct regarding Sham transactions:**
   - **A.** they have significant economic substance or purpose
   - **B.** they are commonly used to deflate earnings or assets
   - **C.** in some cases, they hide the true nature of a transaction
   - **D.** both A and B above

7. **What do most improper asset valuations involve:**
   - **A.** purchase-versus-pooling accounting methods
   - **B.** misclassification of fixed and other assets
   - **C.** improper capitalization of inventory or start-up costs
   - **D.** fraudulent overstatement of inventory and receivables

8. **In creating fictitious accounts receivable, what would the typical entry be:**
   - **A.** to debit accounts receivable and credit sales
   - **B.** to credit accounts receivable and debit sales
   - **C.** to debit accounts receivable and debit sales
   - **D.** to credit accounts receivable and credit sales

9. **What is a common method for improper deferral of costs and expenses:**

   A. omissions of liabilities

   B. capitalization of expenses

   C. failure to accrue enough warranty costs and liabilities

   D. all of the above

10. **Who has the obligation to disclose to the shareholders significant fraud committed by officers, executives, and others in important positions of trust:**

    A. the attorneys associated with the criminal indictment

    B. the management

    C. the auditors

    D. the internal audit department