CASE STUDIES: LEARNING FROM THE SUCCESS OF OTHERS
CASE STUDIES IN FINANCIAL STATEMENT FRAUD

This session reviews recent financial statement fraud cases from around the world to illustrate current trends, the mechanics of how these frauds are perpetrated, and provide guidance on prevention and detection. Learn environmental and internal control characteristics involved, techniques for detecting financial statement fraud, and the evidence to support an allegation of financial statement fraud.

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Financial statement fraud represented only 7.6 percent of the 1,388 fraud cases from 2010 and 2011 studied in the ACFE’s 2012 Report to the Nations on Occupational Fraud and Abuse. It is not unusual for this category of fraud to lag behind the others (asset misappropriations and corruption) in terms of the total number of cases. In the 2010 Report, financial statement fraud represented only 4.8 percent of the cases. But, financial statement fraud tends to be the most damaging. Its median loss of $1 million in the 2012 Report makes the other two categories seem miniscule by comparison.

In the COSO report, Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Public Companies, 347 separate cases were analyzed. The breakdown of cases by method of financial statement fraud was as follows:

- Improper revenue recognition 61%
- Overstatement of assets 51%
- Understatement of expenses/liabilities 31%
- Misappropriation of assets 14%
- Other miscellaneous techniques 20%
- Disguised through the use of related parties 18%

The overstatement of assets category might correlate with inflated revenues, understatement of expenses (e.g., capitalizing costs that should be expensed), or other techniques. This is one of the reasons that the total of the preceding list exceeds 100 percent—indicating that many financial statement frauds involve more than one technique.

The remainder of this paper is devoted to a study of financial statement fraud cases that have had developments during the last two years. While some of the charges may have been made in 2011 or 2012, some of the cases have histories going back quite a few years. Nonetheless, they
represent useful illustrations of some of the techniques that are being employed today in carrying out financial statement fraud.

**Revenue Recognition Schemes**

Improper recognition of revenue accounts for 61 percent of the U.S. cases studied in the COSO report. The report identified the following as the top two schemes within this category:

- Recording fictitious revenues 48%
- Recording revenues prematurely 35%

Within these two broad categories is an endless array of techniques used to inflate revenue. Some of the most commonly employed techniques include:

1. Creation of a fictitious customer to which the company purportedly had sales
2. Addition of fictitious sales to legitimate customers or inflating legitimate sales
3. “Round-tripping” schemes involving sales to alleged customers and then providing funding in one manner or another to the customers to enable them to be able to pay
4. Sales with special terms or conditions that allow customers to hold merchandise without an obligation to pay or that grant lenient return terms
5. Recognizing revenue before all terms of an agreement have been satisfied
6. Inflated or sham sales with related parties
7. Improper application of bill and hold sales transactions
8. Manipulation of percentage of completion contract revenue recognition
9. Disguised consignment sales
10. Inappropriate accounting associated with channel stuffing
11. Unauthorized shipments to customers
12. Keeping the books open beyond the end of a month/quarter/year in order to record additional sales
13. Manipulation of the timing associated with recognition of discounts and other incentives provided to customers

Examples of almost every one of these techniques can be found in cases from the last two years. For purposes of this presentation, a few particularly interesting cases have been chosen to illustrate how these schemes are executed.

**Thornton Precision Components**

In January 2012, four former executives and accountants of the British company Symmetry Medical Sheffield LTD, f/k/a Thornton Precision Components (TPC), were charged for their roles in a massive fictitious revenue scheme that took place between 2004 and 2007. TPC accounted for a significant portion of the consolidated revenues of its parent company, U.S.-based Symmetry Medical, Inc., a manufacturer of prosthetics, medical implants and instruments, and other specialized products for the aerospace industry. Symmetry Medical acquired TPC in 2003 and had its IPO in December 2004.

A timing scheme to recognize revenue early had already been in place at TPC as early as 1999. This timing scheme was initiated in response to TPC lagging behind its monthly sales targets. The shortfall was erased by generating fraudulent sales invoices for manufactured products that were not yet completed. These invoices were, of course, never sent to the customers, but were used internally to support the revenue. This enabled TPC to recognize revenue before actually earning it. When the associated products were finally completed and shipped, TPC credited the
original invoice and issued new ones, this time sending the invoices to the customers. This practice went on from 1999 to 2003, enabling TPC to achieve its sales targets by pulling future revenue into earlier accounting periods—the proverbial borrowing from the future.

But things really got interesting in 2004, when the perpetrators’ strategy shifted from premature revenue recognition to recording completely fictitious revenues. Beginning in 2004, one of TPC’s executives would assess how much TPC fell short of its sales targets on a monthly and quarterly basis. When shortfalls existed, a top-side journal entry would be made debiting accounts receivable and crediting sales. These were internally referred to as “provisional” sales. In an attempt to conceal the fictitious revenue, this individual then sent a record of the provisional sales to another person, who calculated and recorded the fictitious cost of goods sold associated with the fictitious sales. This made TPC’s gross margin remain comparable, at least temporarily.

The top-side sales entries made TPC’s accounts receivable subsidiary ledger out of balance with the general ledger (which had the higher figure for receivables). To hide this from all parties not involved in the scheme (including the external and internal auditors), a fictitious sub-ledger was created in the form of an Excel spreadsheet. This spreadsheet only reflected total accounts receivable and aging by customer and not the details by sale and invoice number normally included in a sub-ledger. The spreadsheet was created from a downloaded copy of a summary version of the real sub-ledger, which was exported into Excel, and the fictitious receivables were then added to the schedule so that it agreed with the general ledger balance.
These fictitious sales had a material impact on the financial statements of TPC. At the close of fiscal year 2005, £12,440,000 (38 percent) of the total reported accounts receivable of £10,717,000 was fictitious. For 2006, £6,031,000 (48 percent) of the reported £12,440,000 was fictitious.

Although the perpetrators of this fraud recorded cost of goods sold to align with the fictitious sales, the scheme also involved a separate effort to inflate inventory balances and, therefore, understate cost of goods sold. This was accomplished using a similar approach to the fictitious accounts receivable—top-side journal entries supported by a falsified inventory sub-ledger containing inserted lines of fictitious work in process inventory, all prepared after the physical count. At the end of fiscal year 2005, only £3,531,000 (36 percent) of TPC’s reported inventory of £9,753,000 actually existed. Cost of goods sold for 2005 was understated (and, therefore, gross profit was overstated) by £2,505,000 as a result of the inventory inflation scheme. At the end of 2006, just £3,692,000 (33 percent) of the reported inventory balance of £10,973,000 was real, and cost of goods sold was understated by £1,058,000.

The incentive behind the TPC schemes was nothing new—pure greed. The perpetrators received bonuses based on the purported performance of TPC, and they profited handsomely from their sale of parent company Symmetry stock.

Carter’s
Carter’s, Inc., is an example of a timing difference scheme perpetrated by a vendor (supplier). In a December 2010 complaint filed by the SEC, Carter’s was charged with manipulating discounts granted by
Carter’s to its largest retail customer, Kohl’s Corporation, from at least 2004 through 2009. The Carter’s case is also a good illustration showing that not all financial statement frauds originate or even involve the accounting department. In fact, some involve the deception of the accounting department by other personnel.

Carter’s is a maker of apparel designed for babies and children, selling under the brand names of Carter’s and Osh Kosh. Consistent with standard business practices in the industry, Carter’s provided some of its customers with discounts (known as accommodations) that could be applied against outstanding invoices. These accommodations, based on the rules described earlier, are to be accounted for as reductions in sales revenue.

The Carter’s scheme involved mismatching, resulting in a timing difference. Under the matching principle inherent in U.S. GAAP and IFRS, expenses or revenue reductions associated with revenue transactions should be recognized in the same accounting period as the revenue. However, in the case of Carter’s, accommodations provided to Kohl’s were often not finalized until either the very end of, or even after, the end of each quarter. Internal controls at Carter’s provided for the creation and approval of internal documentation for accommodations prepared by the sales department that would be forwarded to the accounting department for recording and matching with subsequent use of the discount by a customer.

However, from 2004 through 2009, a senior sales executive of Carter’s began granting excessive accommodations to Kohl’s and concealing these excess accommodations from the accounting department. This
sales executive arranged with Kohl’s for Kohl’s to “delay taking those accommodations for a sufficient amount of time such that each accommodation could be mischaracterized to Carter’s accounting department as an expense of the later period in which it was taken, rather than an expense of the earlier period in which the sale was made.”

Internally, supporting documentation was rigged to coincide with the fraudulent accounting treatment. For each of the falsely deferred accommodations, the sales executive instructed his assistant to wait to generate the documentation for the accommodation until about one week before Kohl’s was “scheduled” to use the discount (which could be several quarters after the accommodation was actually granted). The assistant was also instructed to include inaccurate data on the supporting documentation, particularly information about the original sales date to which the accommodation applied. This tricked the accounting department into matching these accommodations with the wrong (later) sales.

Similar to many other timing difference fraud schemes, the fraudulent deferral of accommodations provided to Kohl’s by Carter’s grew from year to year before it all unraveled. When the scheme began in 2004, total unrecognized accommodations amounted to a little more than $3 million at year-end. By 2009, the unrecorded accommodations had grown to more than $18 million.

Of course, as the amounts involved escalated, the lies extended beyond merely creating false supporting documentation. Even in 2012, additional charges continue to be made in connection with this fraud.
**LocatePlus Holdings**

In late 2010, the SEC charged LocatePlus Holdings Corporation, a seller of personal information used for investigative searches, with inflating its revenue during 2005 and 2006 through the creation of a fictitious customer known as Omni Data Services, Inc. (Omni Data). To make the transactions appear legitimate, Omni Data paid LocatePlus for the sales. However, these payments were actually funded with cash routed through entities under the control of LocatePlus executives. This practice is sometimes known as a *roundtrip transaction*.

For example, in one transaction, LocatePlus made a $650,000 payment to an entity, which then transferred $600,000 to Omni Data, and Omni Data then paid $600,000 back to LocatePlus as purported payment for services. In another transaction, at least $250,000 of the proceeds of unregistered stock sales were transferred to Omni Data, which then transferred those funds to LocatePlus, again as payment for purported services. The improper Omni Data payments were fraudulently included as revenue in LocatePlus’s financial statements.

In total, approximately $2 million was funneled to OmniData in support of phony sales transactions. The effect on LocatePlus’s financial statements was material. Phony sales to Omni Data represented 31 percent of LocatePlus’s 2005 reported revenue and 22 percent of 2006 reported revenue.

In addition to its charges that LocatePlus fraudulently reported revenue from this fictitious customer, the SEC also charged LocatePlus with failing to disclose the fictitious customer as a related party!
Fair Value Accounting and Impairment Losses
Overstating the assets of a company is the second most common form of financial statement fraud, involving 51 percent of the cases in the COSO study. There are numerous methods of inflating the reported assets on the balance sheet, including:

1. Including assets to which the reporting entity does not hold title, such as assets held by unconsolidated affiliated entities
2. Inappropriate capitalization of costs that should be expensed
3. Stretching out the useful lives of depreciable or amortizable assets, resulting in the understating of depreciation/amortization expense
4. Consolidating the accounts of entities over which the reporting entity does not have sufficient control
5. Manipulating physical counts or pricing of inventory
6. Recording fictitious accounts receivable—see the preceding section on revenue schemes
7. Failing to record adequate reserves for uncollectible accounts or loans receivable
8. Failing to write off obsolete inventory or other unused assets
9. Recording phony, unrealized gains on investments held by the company
10. Failure to record impairments and/or other declines in the fair value of financial or nonfinancial assets

The last two categories deal with two important current issues in financial reporting—the determination of whether and when an impairment loss occurs and the manner in which fair value accounting is applied in the preparation of financial statements.

Generally, an impairment refers to a situation in which the book value of an asset exceeds its fair value or net
realizable value (which of these two figures is to be used varies depending on which accounting rule is being applied). The frequency with which the assessment of whether an impairment loss occurs varies with the type of asset. Thus, some assets must be assessed for impairment every year; others only need to be formally assessed if there are signs that an impairment might have taken place. And even when impairment assessment is performed, there is much judgment that goes into the determination of fair value or net realizable value of many assets. Accordingly, the risk of manipulating the assessment can be very high, resulting in possible avoidance or under-recognition of impairment losses.

The rules of fair value accounting have undergone significant changes over the years. A complete description of those rules is beyond the scope and purpose of this paper. For purposes of this paper, all that is needed to review the cases is an appreciation of the complexities involved in measuring fair value, especially with respect to certain assets that are not traded regularly on an active market. Numerous mark-to-model techniques are applied in such situations and the opportunities for manipulation are many.

For today’s presentation, a few interesting recent cases have been selected.

**Olympus**

A major recent case involving a company’s attempts to hide impairment losses is the Olympus Corporation case, which came to light in October 2011. What makes the Olympus case so fascinating is the duration of the scheme (more than 20 years), as well as the methodology.
In response to the increased value of the Japanese yen after 1985, Olympus embarked on a “speculative investment strategy” involving the purchase of higher-risk securities. However, by the late 1990s, unrealized losses on these investments accumulated to nearly JPY 100 billion ($1.3 billion). But what really triggered the scheme was the looming introduction of new fair value accounting rules that would require the recognition of these unrealized losses. Olympus designed a “loss separation scheme” to hide these losses.

Under this plan, impaired assets were sold to off-balance-sheet “receiver funds” that were established and controlled by Olympus. Since these funds were controlled by Olympus, the sales of assets were done at the assets’ book values, not at the lower, impaired values.

The receiver funds were able to pay Olympus for the acquired assets because the funds were financed by third-party financial institutions. These loans were secured with collateral pledged by Olympus. The receiver funds then acquired certain growth companies (three Japanese companies between 2003 and 2005 and one British company, Gyrus Group PLC, in 2008).

Later, Olympus purchased these growth companies from the receiver funds. These purchases were at inflated prices and with the payment of exorbitant advisory fees, enabling the receiver funds to repay the financial institutions, get the Olympus collateral released, and cover their operating expenses. Basically, the inflated purchase prices and advisory fees covered the hidden unrealized losses on the assets initially sold by Olympus to the receiver funds.
The excess purchase price paid by Olympus for the growth companies was then recorded as goodwill, which could then be written down over time. The end result of this scheme is that unrealized losses of Olympus were converted into goodwill, enabling the deferral of any loss to future periods, when the goodwill could then be impaired. In some cases, Olympus recorded a write-down in value very soon after the acquisition. Some of the companies that were acquired had no revenue or business history, raising doubts about whether these companies were even legitimate businesses.

One of the factors that aided in this accounting trick, referred to as *tobashi*, was the fact that the transactions were supported by cash changing hands. This was not merely an accounting journal entry made to hide losses.

Shares of Olympus fell by more than 80 percent from October 13, 2011, just prior to the fraud becoming public, to November 11, 2011, three days after the company admitted to the wrongdoing.

**Bank of Montreal**

An excellent example of fraudulent application of a valuation model is a case involving Bank of Montreal, which restated its financial statements by CAD $237 million in 2007 as a result of a valuation fraud. The valuations involved natural gas options that were traded by one of the bank’s senior commodity traders.

At Bank of Montreal, similar to other financial institutions, each commodity trader was responsible for assigning fair values to their books each day. If the derivatives involved were actively traded on a recognized market, the mark-to-market basis was used
in valuing the derivatives (i.e., the market method, as explained earlier). However, when no such market existed, a computerized mark-to-model approach was used (generally, a variation on one of the many income approaches described in the preceding section). The mark-to-model method involved having the traders provide the data inputs, which included fixed inputs, such as an option’s expiration date, as well as variable inputs that required some calculation on the part of the trader.

When a mark-to-model method was used, Bank of Montreal’s internal controls required that an independent price verification be obtained. If the independent price was lower than the value calculated by the trader, a valuation reserve for the difference was to be established. The selection of the outside party to provide the independent valuation was done by personnel from a separate department outside that of the trader, providing for a segregation of duties.

This is where things begin to unravel for Bank of Montreal. The trading unit had successfully resisted efforts from the other unit of the bank to use a multi-contributor independent valuation service. As a result, the same outside company, Optionable, had been used exclusively as the broker for the trades and to verify the trader’s valuations since 2003. And a relationship developed between the Bank of Montreal trade and three individuals at Optionable. By its own account, Optionable earned 24 percent of its 2006 brokerage revenues from the trades carried out by the one Bank of Montreal trader. In effect, earning so much of its revenue from a single source impaired Optionable’s independence, creating the incentive to cooperate with the trader at Bank of Montreal.
This relationship led to the practice of *u-turning*, in which the three individuals at Optionable simply returned values to Bank of Montreal’s back office mirroring those provided by the trader. How this worked was simple. Optionable provided Bank of Montreal’s back office with fair value quotes twice a month. The trader engaging in the fraudulent valuations would email his list of inflated values to his contacts at Optionable, easily circumventing the internal control that Bank of Montreal thought was in place. Later that same day, Optionable would email its list of supposedly independent values to Bank of Montreal’s back office. These emails contained values exactly matching those of the trader, thus covering up the inflated values. Over the six quarters from November 1, 2005, through April 30, 2007, the Bank of Montreal trader overvalued his book by a total of CAD $680, of which CAD $432 million was attributable to the trader’s fraud.

The Bank of Montreal trader’s compensation grew enormously as a result of his fraud. In 2003 and 2004, he received annual bonuses of approximately CAD $650,000. However, the bonus jumped to more than $3 million in 2005, the year the fraud began in earnest. His 2006 bonus rose to $5.35 million.

The three individuals at Optionable also profited. Two senior executives who owned stock in the company made $10 million when they sold shares in Optionable stock in 2007. And a third person, who assisted the two executives, received large bonuses for cooperating.

The unraveling of the fraud scheme began in the summer of 2006 when, after a lengthy battle between the two groups at Bank of Montreal, the bank finally subscribed to a multi-contributor valuation service.
called Totem. Totem’s valuations came in below those of the trader and Optionable. After repeated efforts by the fraudulent trader to manipulate these values, by early 2007 the scheme came to an end.

In addition to the impact on Bank of Montreal, the shareholders of Optionable also felt the effects of the fraud once it came to light. Shares of Optionable stock fell by 82 percent in just two days after the report of Bank of Montreal suspending its relationship with Optionable. Additional subsequent declines brought the total hit to more than 90 percent.

**Sterling Financial**

In January 2011, the SEC charged one company and some of its executives with an elaborate scheme designed to improve the appearance of a loan portfolio. This case involved Sterling Financial Corp. and, in particular, a wholly owned subsidiary of Sterling, Equipment Finance, LLC (EF). EF was a commercial lender, holding financing contracts with forestry and land equipment dealers through which EF provided loans. The SEC complaint charged two of EF’s executives with subverting “virtually every aspect of EF’s loan process and internal controls” to engage in a variety of schemes designed to inflate the size and quality of EF’s loan portfolio. Among the fraudulent tactics employed were:

1. Creating fictitious loans for the purpose of making payments on delinquent loans (these loans were made in the names of legitimate customers but without the customers’ knowledge)
2. Altering documents in loan files to hide delinquent and fictitious loans, including falsifying loan documents to reflect a 20 percent down-payment, as required by EF policy, when there was no such
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3. Granting excessive deferrals (moving delinquent loan payments to the end of the loan term) without the customers’ consent and resetting delinquent loans (which resulted in a refinancing) to make them appear current

4. Reassigning loan payments to unrelated accounts to fund payments on delinquent loans

5. Using aliases for borrowers to circumvent EF’s maximum lending limitations

As a result of the fraud, Sterling ultimately charged off $281 million of EF finance receivables, which represented a large majority of EF’s loan portfolio, and approximately 13 percent of Sterling’s total loan portfolio during the period of the fraud. Sterling reported the fraud in 2007, and the company was acquired by another financial institution in 2008.

Financial Statement Fraud to Concel Asset Misappropriations

Another incentive for perpetrating financial statement fraud is to conceal an asset misappropriation. This is particularly the case with respect to asset misappropriations carried out by high-level individuals, such as senior finance personnel or other senior managers, who might be in a position to disguise their theft in the accounting records.

At noted earlier, the COSO study of financial statement frauds carried out in the U.S. between 1998 and 2007 found that 14 percent of the cases involved a misstatement resulting from or used to conceal an asset misappropriation.
Koss Corporation
No recent case better illustrates this risk than Koss Corporation, a Wisconsin-based manufacturer and seller of stereo headphones. From 2005 to 2009, the Principal Accounting Officer and Vice President of Finance, Sujata Sachdeva, stole more than $30 million from Koss. As large as this amount is, even more amazing is how material this theft was to Koss. For example, during fiscal year 2009, when $8.5 million was embezzled, Koss reported total sales of $41.7 million. More than 20 percent of its total reported sales stolen!

The methods used to steal from Koss were relatively simple. More than $15 million was in the form of unauthorized cashier’s checks. Another $16 million in fraudulent wire transfers were made, all of which were to pay various personal credit card bills and other purchases made by Sachdeva. In October 2009 alone, evidencing Sachdeva’s growing addiction to stealing from Koss, 17 wires totaling more than $1.5 million were made on Sachdeva’s personal credit card.

Sachdeva, with the assistance of the Senior Accountant, Julie Mulvaney, circumvented Koss’s internal controls in the process. None of the cashier’s checks or wire transfers was approved by Michael J. Koss, the CEO, or Koss’s Vice President of Operations, as required by company policy (which required all disbursements exceeding $5,000 to be approved by the CEO).

The massive embezzlement was hidden from the CEO and others with a series of journal entries. Once unraveled, the credits to (reductions in) cash associated with the unauthorized cashier’s checks and wire transfers were offset by debits to:
1. Sales (thus reducing net sales)
2. Cost of sales (overstating cost of sales)
3. Accounts receivable (inflating this asset)
4. Administrative expenses (overstating operating expenses)

In addition, cash was overstated because the embezzlement of some of the funds was never recorded anywhere in the accounting records. As a result, the cash accounts did not reconcile.

When Koss restated its 2008 and 2009 financial statements after discovering the embezzlement, the net effect of the embezzlement was reported as operating expenses.

The Koss case represents a failure in internal controls in so many ways. Among the weaknesses in internal controls cited by the SEC in its civil complaint against Koss and its CEO were the following:
1. The lack of documentation for journal entries
   (weaknesses over journal entries enabled Sachdeva and Mulvaney to conceal the fraud)
2. Lack of segregation of duties over disbursements and the bank reconciliation process (all controlled by Sachdeva and Mulvaney)
3. Failure to perform monthly bank reconciliations
4. No review of wire transfers was required in order for a wire to be executed
5. No after-the-fact review of journal entries
6. A very cursory review of financial information by the CEO (e.g., no review of the trial balance, journal entries, or schedules)
7. Very limited monthly analytical procedures, insufficient to detect unusual relationships or trends (such as the shrinking gross margin caused by
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<td>reducing sales and increasing cost of sales to conceal the asset misappropriation)</td>
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<td>8. A very old and weak accounting system, leaving little to no audit trail, enabling post-closing entries and other weaknesses</td>
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<td>9. Failure to change access passwords on a regular basis, along with several other information technology control deficiencies</td>
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<td>So much for the thought that all public companies are inherently able, due to their size, to have stronger segregation of duties and internal controls in place than small companies!</td>
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