Association of Certified Fraud Examiners

ACFE

Together, Reducing Fraud Worldwide

Case Studies in Financial Statement Fraud

By

Gerry Zack, CFE, CPA, CIA, CCEP

Zack, P.C.

www.zackpc.com

Financial Statement Fraud

- Historically represents a small percentage of fraud cases
  - 7.6% of cases in the 2012 ACFE *Report to the Nations*
- But, it is usually the most material
  - Median loss of $1 million in the 2012 ACFE *Report to the Nations*

COSO Report

- Studied U.S. Public Companies from 1998–2007
- 347 cases
- FS Fraud cases as follows:
  - Revenue recognition in 61% of cases
  - Overstated assets in 51%
  - Understated liabilities/expenses in 31%
  - Misappropriation of assets in 14%
  - Other techniques in 20%

Revenue Recognition Schemes

- Fictitious revenue – 48%
- Premature revenue (timing schemes) – 35%

Revenue Schemes (1)

1. Fictitious customers
2. Fictitious/inflated sales to actual customers
3. Round-tripping
4. Sales with special terms
5. Revenue recognition prior to meeting all terms
6. Sales with related parties
7. Bill and hold transaction abuse

Revenue Schemes (2)

8. Percentage of completion schemes
9. Disguised consignment sales
10. Channel stuffing schemes
11. Unauthorized shipments
12. Keeping the books open beyond end of period
13. Manipulation of customer incentives and discounts

Thornton Precision Components

- Now known as Symmetry Medical Sheffield LTD
- January 2012 charges filed
- Revenue timing scheme from 1999–2003
  - Phony internal sales invoice, despite incomplete products
  - Reversed and re-invoiced when products completed and shipped
- Fictitious revenue from 2004–2007
  - Top-side entries for sales equal to shortfall in actual sales
  - Recorded fictitious COGS to maintain realistic gross margin
  - IPO in December 2004

Thornton Precision Components (2)

- Concealment
  - Creation of fictitious A/R sub-ledger in Excel
  - Created from downloaded copy of the real sub-ledger, exported into Excel
  - Fictitious receivables then inserted
  - Reflected only total A/R by customer, w/o detail
  - Agreed to inflated GL balance
- The effects of this fraud—A/R inflated by:
  - £4,122,000 (38%) for 2005
  - £6,031,000 (48%) for 2006

Thornton Precision Components (3)

- Second scheme used similar approach to inflate inventory
- Incentive—perpetrators received bonuses based on financial performance of the company, and they also cashed in on their sale of stock

Carter's

- Maker of children's apparel
- Timing scheme involving discounts ("accommodations") granted to its largest customer, Kohl's
- Took place from 2004 to 2009
- Involved deception <u>of</u>, not by, the accounting department
- Timing scheme

Carter's (2)

- Documentation for accommodations prepared by sales dept., forwarded to accounting for recording and matching with subsequent use by customer
- Senior sales exec granted excessive accommodations to Kohl's, concealed from accounting
- Arranged for Kohl's to delay in taking the accommodations
- Mischaracterized as discount of subsequent period (when taken by Kohl's)

Carter's (3)

- Phony documentation submitted to accounting about one week before Kohl's was "scheduled" to use the accommodation
  - Included false information about the original sales date to which the accommodation applied
- Started at $3 million at YE 2004; Grew to more than $18 million by YE 2009
- Charges still being filed in 2012

LocatePlus Holdings

- Charged in 2010 by SEC with inflating 2005–2006 revenues
- Created a fictitious company—Omni Data Services
- To make sales appear real, ODS paid LocatePlus
- But ODS was funded w/cash routed through entities under control of LocatePlus execs
  - A practice known as “roundtrip transactions”
- Total of $2 million in bogus sales
  - 31% of 2005 reported revenue
  - 22% of 2006 reported revenue

Asset Inflation Schemes

1. Including assets not under reporting entity's control or ownership
2. Improper capitalization of costs
3. Extending useful lives of assets
4. Consolidating entities not under control
5. Manipulating physical counts of inventory
6. Recording fictitious accounts receivable

Asset Inflation Schemes (2)

7. Insufficient reserves for uncollectible receivables
8. Failing to write off obsolete inventory or other unused assets
9. Phony unrealized gains
10. Failure to record impairment losses

Asset Impairments

- Slightly different rules depending on the type of asset (investments, intangible assets, long-lived assets such as property and equipment)
- Generally, an impairment exists when an asset’s net book value is greater than its:
  - Fair value or
  - Net realizable value
- Determining fair value or net realizable value is where the challenge (and the opportunity for fraud) come into play

Olympus

- Story broke in October 2011
- Practice had been going on for more than 20 years
- Mid-1980s—Olympus embarks on new investment strategy, higher risk securities
- Late 1990s—Large unrealized losses had accumulated, and new fair value accounting rules pending would require recognition of losses
- Introduction of a "loss separation scheme," which hid $1.3 billion (100 billion JPY) in losses

Olympus' "Loss Separation Scheme"

- Impaired assets sold to off-balance-sheet "receiver funds" that were established and controlled by Olympus
- Assets were sold at book value, not the (lower) impaired value
- Receiver funds financed purchases of impaired assets through third-party financial institutions
- Loans were secured with collateral pledged by Olympus

Olympus' "Loss Separation Scheme" (2)

- Receiver funds then purchased certain growth companies
- Next—Olympus purchased the growth companies from the receiver funds
  - At inflated prices
  - Including the payment of exorbitant advisory fees
  - Excess recorded as goodwill by Oympus
  - Enabling receiver funds to repay bank loans
  - Which results in release of collateral pledged by Olympus
  - And the unrealized losses are now gone! Converted into goodwill!
  - Tobashi!

Bank of Montreal

- CAD $237 million restatement in 2007
- Fraudulent application of a valuation model
- Natural gas options traded by one of the bank's senior commodity traders
- Derivatives were assigned fair values every day
  - Mark-to-market method if actively traded
  - Mark-to-model method if not actively traded

Mark-to-Method Model at B of M

- Computerized model
- Trader provided data inputs
  - Fixed (e.g., an option's expiration date)
  - Variable (requiring judgment or calculation by trader)
- Internal controls required independent price verification
  - Selected by separate department, not by trader
- If independent price < model value, valuation reserve established for the difference

B of M—How Things Went Bad

- Trading department resisted efforts to utilize a multi-contributor independent valuation service
- As a result, the same outside company (Optionable) was used since 2003
- Relationship developed between the B of M trader and three Optionable individuals
- 24% of Optionable's 2006 brokerage revenue came from trades executed by the one B of M trader
  - Impairment of independence
  - Creates incentive for Optionable to cooperate with trader

B of M—How Things Went Bad (2)

- Optionable began engaging in "u-turning"
  - Optionable provided "independent" values to B of M's back office that mirrored exactly the values provided by the B of M trader
  - Done twice a month
  - Preceded by an email from trader listing his values (inflated)
  - From November 2005–April 2007, trader overvalued his book by a total of CAD $680 million
- B of M trader's compensation grew tremendously
  - 2003 bonus = $650,000
  - 2004 bonus = $650,000
  - 2005 bonus = $3 million
  - 2006 bonus = $5.35 million

Bank of Montreal

- Optionable personnel also benefited
  - Two senior execs made $10 million profit selling shares of Optionable in 2007
  - Third person (assistant) received large bonuses
- How it unraveled:
  - Summer of 2006—bank finally subscribed to multi-contributor valuation service (Totem), after lengthy battle with trading group
  - Totem's valuations were much lower, reflecting reality
  - By early 2007, the scheme came to an end
- Stock price of Optionable fell by more than 90%

Sterling Financial

- 2001, SEC files charges against company and its executives
- Nature of charges—fraudulently making a loan portfolio appear stronger than it really was
- Pertained to a wholly owned subsidiary, Sterling Equipment Finance, LLC (EF), a commercial lender dealing with forestry and land equipment dealers
- Charges included subverting “virtually every aspect of EF’s loan process and internal controls”

Sterling Financial—The Scheme

- Creation of fictitious loans for purposes of making payments on delinquent loans
  - Made in the names of legitimate customers, but without their knowledge
- Altering documents in loan files to hide delinquencies
  - Falsifying docs to reflect 20% down payments (EF policy)
  - Creation of phony UCC filing docs
  - Alerting credit reports

Sterling Financial—The Scheme (2)

- Granting excessive deferrals
  - Moving delinquent payments to the end of the loan term
  - Done without customer consent
  - Resetting delinquent loans, resulting in a refinancing, to make them appear current
- Reassigning loan payments to unrelated accounts to fund payments on delinquent loans
- Using aliases for borrowers to circumvent EF's maximum lending limitations

Sterling Financial

- $281 million in hidden bad loans eventually charged off
  - Majority of EF's loan portfolio was bad
  - Represented 13% of Sterling's consolidated loan portfolio
- Acquired by another financial institution in 2008

Reasons for FS Fraud

- Make a company look healthier, more profitable, in order to mislead
  - Investors (shareholders, buyers of privately held businesses)
  - Bankers (maximize borrowing capacity)
  - Investment managers
  - Regulators
  - Insurance companies
- Hide an asset misappropriation
  - 14% of FSF cases in COSO study of 1998–2007 misstatements

Koss Corporation

- Wisconsin-based seller of stereo headphones
- Principal Accounting Officer & VP Finance stole more than $30 million from 2005 to 2009
  - Material to Koss
  - Example: 2009 theft of $8.5 million; Sales for 2009 = $41.7 million
- Methods used to steal funds:
  - $15 million in unauthorized cashier's checks
  - $16 million in fraudulent wire transfers (paying personal credit cards and other personal purchases)
- As with many frauds, the greed grew
  - In October 2009 alone, 17 wire transfers for $1.5 million

Koss Corporation (2)

- Circumvention of internal controls
  - None of the cashier's checks or wires were approved by Michael Koss, CEO, or the VP Operations
  - Company policy required all disbursements > $5,000 to be approved by the CEO
- Concealment consisted of a series of journal entries resulting in the theft being recorded as:
  - Reductions in sales
  - Cost of sales
  - Accounts receivable
  - Administrative expenses
  - Cash

Loss Corporation (3)

- In addition, cash was overstated due to some embezzlements not being recorded at all
  - Cash accounts did not reconcile to the bank statements
- When the 2008 and 2009 financial statements were restated, theft was classified as other operating expenses

Koss Internal Control Deficiencies

1. Lack of documentation for journal entries
2. Lack of segregation of duties over disbursements and bank reconciliations
3. Failure to perform monthly bank reconciliations
4. Lack of required review of wire transfers prior to execution (note the distinction between a preventive policy and a preventive control)
5. Lack of an after-the-fact review of journal entries

Koss Internal Control Deficiencies (2)

6. Lack of detailed review of financial information by CEO (very cursory)
7. Insufficient monthly analytical procedures (e.g., no monitoring of even gross margins)
8. Old and weak accounting system, leaving little audit trail and enabling post-closing entries, among other weaknesses
9. Failure to change passwords on a regular basis, along with other IT security and control deficiencies

Questions ???

CONTACT INFORMATION

GERARD ZACK, CFE, CPA, CIA, CCEP
ZACK, P.C.
WWW.ZACKPC.COM

GERRY@ZACKPC.COM

301.987.0287

“Association of Certified Fraud Examiners,” “Certified Fraud Examiner,” “CFE,” “ACFE,” and the ACFE Logo are trademarks owned by the Association of Certified Fraud Examiners, Inc. The contents of this paper may not be transmitted, re-published, modified, reproduced, distributed, copied, or sold without the prior consent of the author.