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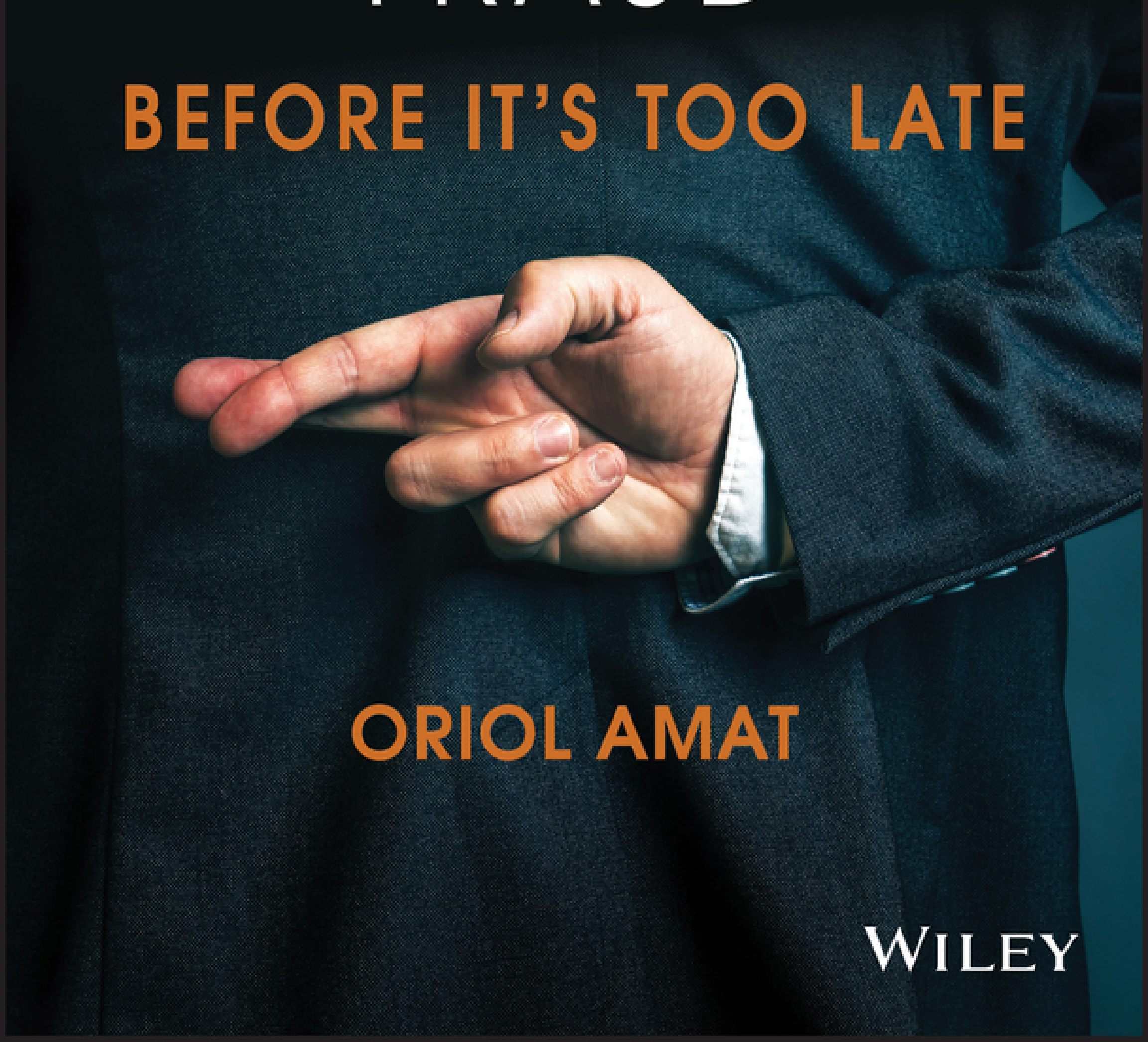
DETECTING ACCOUNTING FRAUD

BEFORE IT'S TOO LATE



ORIOL AMAT

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To Pilar, Mireia, Natàlia, Marc, Lluis, and Anna.

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Prologue

I consider myself an expert on corporate manipulation and fraud. I researched the issue extensively and was an expert witness in numerous lawsuits of corporate misinformation and fraud. I am also a CPA and have taught accounting for decades. So, I really didn't expect to learn a lot from yet another book about corporate fraud. What a surprise! *Detecting Accounting Fraud Before It's Too Late*, by Professor Oriol Amat, a well-known and prolific accounting scholar, is full of new facts, insights, and useful prescriptions about corporate fraud and information manipulation. What a delight to learn so many new and practical things from this book. It's also great fun to read. Did you know, for example, that fraud already existed in Mesopotamia in 1700 B.C.?

Information manipulation by public companies is prevalent. In the United States, more than 70% of public companies regularly beat analysts' consensus earnings estimates. This cannot be done without certain a "management" (an elegant term for manipulation) of analysts' estimates, reported earnings, or, in many cases, both. Accounting and finance research documents extensively numerous cases of corporate misinformation and reporting fraud. There is no doubt that this phenomenon is, regrettably, quite prevalent. But the evidence is scattered, and often anecdotal. There is, therefore, a need for a comprehensive, in-depth, and practical discussion of corporate fraud. This is provided by *Detecting Accounting Fraud Before It's Too Late*.

The book appropriately starts with a definition of financial reporting manipulation: intervention in the process of preparation of financial information to affect investors' perceptions. It goes on to note that 11% of all corporate-fraud cases involve accounting manipulations, closely behind theft and bribery. So, the book deals with a serious, worldwide phenomenon.

The main contribution of this book is in its wide scope. It opens with a fascinating historical perspective of infamous fraud cases: from Mesopotamia, through the Dutch East India Company in 1600, and ending with the recent scandals of Enron and Lehman Brothers. It then continues with a thorough treatment of information fraud, starting with the major means of fraud: accounting manipulations—using accounting procedures, such as manipulating the multiple estimates underlying financial reports, to change reported information, and real manipulations—cutting, or delaying expenditures, such as R&D, advertising, or maintenance to inflate reported earnings. The discussion of the means, or techniques, of fraud is demonstrated by multiple real-life fraud cases.

The book then moves to the important topic of who wins and who loses from financial information fraud. It turns out that in many cases the losers are the innocent bystanders: employees and customers who are seriously harmed by the implosion of fraudulent companies, like Enron and WorldCom. So, this is an important societal issue.

Next is a discussion of fraud prevention and the role of corporate governance in mitigating fraud. Finally, and this is a unique and an important contribution of this book, the author offers an evidence-based list of fraud warning signs (red flags). For convenience, the individual warning signs are combined into a fraud index that yields a unique number. This is very useful: Investors can rank companies, using the fraud index, by susceptibility to financial information fraud.

Detecting Accounting Fraud Before It's Too Late is thus a very important contribution to the growing literature on financial manipulation and fraud. Investors, corporate managers, and public policymakers in economics and capital markets will find this book very useful. It can also serve as textbook for the many college corporate fraud and forensic accounting courses.

Baruch Lev
Philip Bardes Professor of Accounting and Finance
at New York University Stern School of Business

Introduction

Companies' financial information is essential for making decisions. For example, to study stock acquisition, grant a loan, or evaluate the company's management team. But there are many decisions regarding marketing, human resources, technology, or any other dimension of the company in which knowledge of the company's financial situation is decisive.

Therefore, it is essential that the accounts be reliable, because otherwise erroneous decisions can be made and in addition trust in the company may be lost.

However, problems of accounting reliability often occur. As an example, we recall a 2014 PriceWaterhouseCoopers (PwC) report that shows that in the two previous years, accounting fraud occurred in 11.2% of companies worldwide. It is 8.6% at the European level.

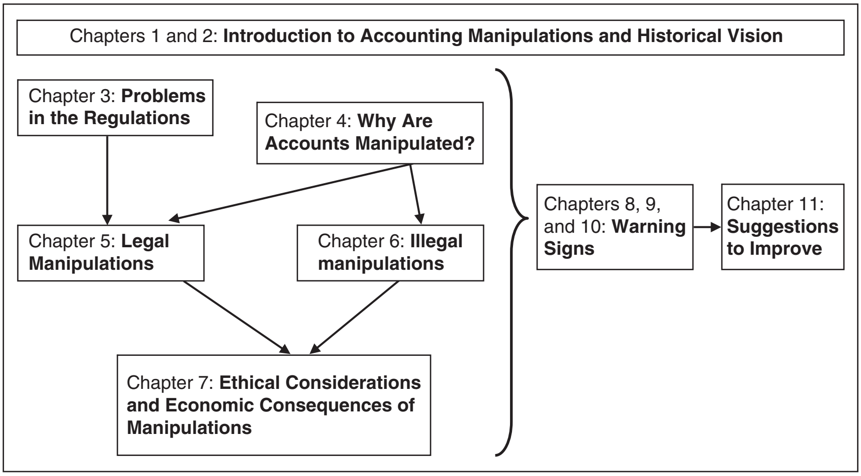
Accounting manipulation is a problem that causes concern, especially when it is repeated frequently, a circumstance that occurs mainly in years of economic crisis, since, with the fall of economic activity, the numbers deteriorate and more managers fall into the temptation to hide that things aren't going well. This concern motivates our interest in detecting fraud before it is too late.

On this topic, in 1996 we wrote the book *Creative Accounting* in cooperation with the late professor John Blake. Twenty years later the problem continues to exist, albeit with different dimensions, as the world of business, as well as the accounting and mercantile legislation, has undergone significant changes. In some aspects it has improved, but in many others it has gone backward.

This book describes and analyzes the nature of accounting manipulations, its motivations and also proposes several techniques to detect these practices.

In order to present the different topics in a more practical way, several real cases are described. Since some of these cases are recent events that are still being settled in court, the affected companies' names were omitted.

At the end there are suggestions that can help reduce accounting manipulations or, in case they occur, to detect them in time. The following figure shows the outline of the book:



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CHAPTER 1

Fraud and Accounting Manipulations

A gray area where the accounting is being perverted; where managers are cutting corners; and where earnings reports reflect the desires of management rather than the underlying financial performance of the company.

—Arthur Levitt, Chairman of the SEC (Securities and Exchange Commission, US stock market regulator and supervisor), 1998

1.1 FRAUD AND ITS EFFECTS

A fraud is the action of deceiving someone to obtain an unjust or illegal benefit. According to the Association of Certified Fraud Examiners (ACFE—the international reference organization in relation to fraud detection), the main types of business frauds are:

- Theft of assets: cash, overpriced merchandise, inflated expenses, employees who are paid but aren't working.
- Corruption: conflict of interests, bribery, illegal gifts, extortion.
- Accounting manipulation: overvaluation (or undervaluation) of assets, liabilities, expenses, and income. (ACFE 2016)

In recent years, the relevance of cybercrime or computer crime, which is fraud done through information technology (IT) tools or with the aim to destroy and damage computers, electronic media, and internet networks, has been increasing. Thus, according to a PricewaterhouseCoopers (PwC) global survey regarding business fraud, cybercrimes are already the second most frequent type of crime behind assets theft (PwC 2016).

Continuing with the ACFE (2016), the different types of fraud cost companies around 5% of their sales figure. This is a very relevant loss if we compare it, for example, to the average profit of companies, which in good years is around 3% of sales (ACCID, 2016). This loss is caused by accounting manipulations (68%), asset theft (21%), and corruption (11%) of the total losses caused by business frauds.

In another study (KPMG, 2010) referring to Europe, 34.5% of executives surveyed indicated that their companies had been subject to some form of fraud in the past 12 months. Of all frauds, 11% were accounting manipulations, the third most important behind theft (28%) and bribery and corruption (13%). These data show that accounting manipulation is a very important issue due to its frequency and the losses it generates.

Accounting manipulation consists in intervening in the process of preparation of the financial information in order to ensure that the accounts present a different image than the one it would offer if the manipulation hadn't been done. It is a serious problem, because it affects the reliability of the accounts. Manipulations are done so the accounts reflect what executives and managers want them to. This way, the reality isn't reported and users of the accounts are deceived.

1.2 MODIFYING COMPANIES' FINANCIAL INFORMATION

Accounts can be modified through accounting notes or real transactions, which can be legal or illegal (see Figure 1.1):

- **Legal accounting manipulations:** These are postings that, in principle, do not infringe the accounting regulations, since they take advantage of the alternatives established in the legislation, the possibilities of making

	Accounting Manipulations	**Actual Transactions**
Legal	These are manipulations (see Chapter 5) that take advantage of: • The alternatives provided in the legislation • The possibilities of performing more or less optimistic forecasts • The legal gaps in aspects not regulated by the regulations	Perform actual transactions that affect companies' accounts (for example, advance or delay a transaction; or sell to clients with low credit rating).
Illegal	Accounting manipulations that violate the legislation (see Chapter 6). For example, conceal or inflate assets, debts, sales, or expenses.	Actual operations that aren't authorized by current legislation (for example, illegal transactions with companies located in tax havens).

FIGURE 1.1 Classification of account manipulation practices

more or less optimistic estimations and the legal gaps. Many authors call this type of manipulation *creative accounting*, although there isn't unanimity, as some people use this denomination to refer to illegal accounting manipulations. This topic is expanded on in Chapter 5.

- **Illegal accounting manipulations:** These are practices not allowed by current legislation (concealing sales or expenses, posting fictitious sales or expenses, concealing assets or debts, and so on). By violating the current legislation they can have legal consequences as they are accounting offenses. It is a topic that is expanded on in Chapter 6.
- **Legal real transactions:** These are real and legal operations designed to make the accounts show the image of interest. Examples of this are:
  - Selling properties to generate exceptional results in the desired moment.
  - Selling assets and then repurchasing them to materialize results.
  - Delaying the delivery of merchandise so it enters the next accounting year.
  - Advancing or delaying investments.
  - Increasing or reducing expenses easily modifiable by the company, such as training or advertising.
  - Invoicing between companies of a group to transfer results among themselves.
  - Increasing the sale of products to distributors (increasing excessively their warehouses) with the aim to improve results.
- **Illegal actual transactions:** These are actual operations that are not legal. Examples would be sales at prices different from market prices through third companies or subsidiaries in tax havens, which alter the company's profits, assets, or liabilities.

INFLATING THE BENEFITS OF COCA-COLA IN JAPAN WITH ACTUAL TRANSACTIONS

Between 1997 and 1999, Coca-Cola Japan modified the commercial conditions to its distributors so they would buy more, although it excessively increased their warehouse inventories. At the end of 1999, the distributors' warehouse levels had increased by 60% and were unsustainable. Coca-Cola told the SEC that it would modify its policy to reduce the distributors' warehouse, but the SEC described this whole operation as "misleading" and that it had been done to fictitiously inflate profits to meet the analysts' profit estimates.

1.3 CALLING THINGS BY THEIR NAME: FROM CREATIVE ACCOUNTING TO BIG BATHS

There are several names for accounting manipulations. Thus, in the United Kingdom, when referring to accounting manipulations the expression *creative accounting* is used. The term creative accounting is also used by many authors to refer to accounting manipulations done without violating current legislation. *Aggressive accounting* refers to manipulations done to increase profits.

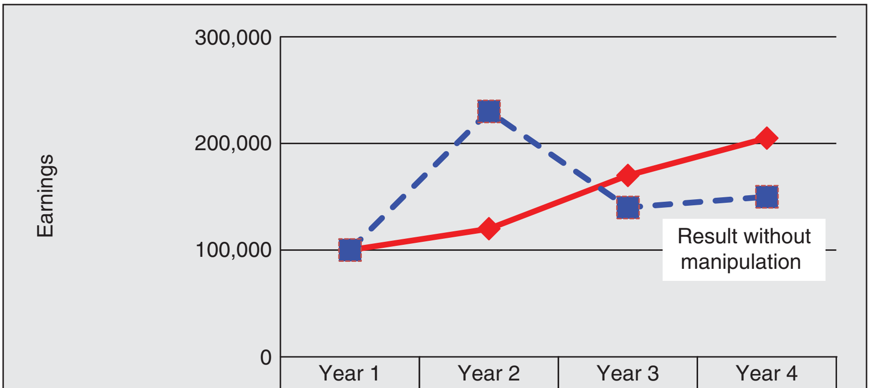
The term *earnings management* is predominant in the United States and usually refers to legal accounting manipulations. On the other hand, when the manipulations are illegal, they are called *earnings manipulations*. Although these denominations seem to refer only to manipulations that affect earnings, in practice, they are used for all types of accounting manipulations.

In the United States, terms like *accounting shenanigans* and *income smoothing* are also used. Income smoothing aims to avoid the negative effects of the volatility of the results. It is a variant of earnings management that consists in transferring results from one year to another, reducing the earnings in good years and thus being able to increase them in following years. This transfer is done, for example, by recording significant deteriorations in one year, which are annulled in a future year. This way, the profit of the first year is reduced and, instead, it increases in the future.

Income smoothing can be done with three types of practices:

1. Year in which the transaction takes place. For example, a property can be sold at the end of December or, at the beginning of January and, therefore, in the following accounting year. By choosing the specific moment in which the transaction is done, we can determine the result of each year.
2. Allocation of expenses and income throughout different years. For example, depreciations and provisions are items that can be distributed over a greater or a lesser number of years.
3. Place where an item is classified. For example, an item of expenses or income can be included in ordinary or exceptional results (or results of continued or discontinued operations) according to the interest, thus varying the image offered by the accounts.

The two examples in Figure 1.2 show the difference in the earnings caused by the income smoothing practice.



	Year 1	Year 2	Year 3	Year 4
Official result	100,050	120,000	170,000	205,000
Result without manipulation	100,050	230,000	140,000	150,000

FIGURE 1.2 A bank's result with and without income smoothing

Income Smoothing at Nortel

In 2007, Nortel Networks, an American company of telecommunications and IT, was accused by the Securities and Exchange Commission (SEC) of accounting fraud for fraudulently reducing (with an excess of provisions) the earnings of 2002 by 350 million dollars. This accounting fraud allowed transforming the losses of 2003 into profits by annulling the excess of provisions of the previous year.

Income Smoothing at a Bank

A real bank, in year 2, considerably raised the goodwill's impairment of several subsidiaries, with the aim of reducing that year's earnings that had been very high. This manipulation (see Figure 1.2), consisting of some extremely pessimistic estimates regarding the future of the subsidiaries, enabled increasing the profits of years 3 and 4. On the other hand, the declared earnings (see continuous line) increase every year, which presents a more favorable situation. Income smoothing gives those who do it an additional advantage that allows making use of privileged information. For example, if a company lowers its profits aiming to increase them in the future, it is information that allows anticipating that in the future, the price of the company's shares will increase (when the increase in profit is reported).