Financial Reporting Fraud

[Jeanne H. Yamamura]:

Financial Reporting Fraud

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Hope and Fraser (2003)

- Setting performance target with incentives = Dysfunctional behavior
- Cannot identify individual contribution
- Temporary behavior change
- Incentives undermine real interest

[Jeanne H. Yamamura]:

Hope and Fraser (in 2003) argued that setting a performance target and supporting it with incentives automatically causes dysfunctional behavior. The dysfunctional behavior occurs because: 1) it isn’t really possible to identify an individual’s contribution (so that he/she can be properly rewarded); 2) the incentives create a culture of fear (you cannot fail to meet the target); 3) the incentives provide a temporary behavioral change at best; and 4) the incentives undermine interest in the work itself.

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2012 Report to the Nations on Occupational Fraud and Abuse

- Association of Certified Fraud Examiners (ACFE)
- Survey of > 34,000 CFEs in Fall 2011
- Financial statement fraud
- Median loss of $1mm
  [Picture Shown]

[Jeanne H. Yamamura]:

While you might disagree with Hope and Fraser’s fairly severe judgment of incentives, it is clear that such incentives have frequently resulted in an extremely damaging dysfunctional behavior – financial statement fraud (or as it’s also known, financial reporting fraud). The Association of Certified Fraud Examiners (ACFE) regularly publishes reports on fraud topics. The 2012 Report to the Nations on Occupational Fraud and Abuse surveyed more than 34,000 Certified Fraud Examiners in Fall 2011. The Report identified financial statement fraud as the most costly type of fraud occurrence with a median loss of $1 million even though they occurred least often.
Recent Frauds

- Olympus
- Satyam Computer Services
- Parmalat
- World Com
- Tyco
- Qwest

[Picture Shown]

[Jeanne H. Yamamura]:

Over the past decade, many large and extremely costly financial statement frauds have occurred. For example, Olympus, Satyam Computer Services, Parmalat, World Com, Tyco, and Qwest Communications. Given the frequency of occurrence and the widespread damage resulting from such frauds, managers need to understand what financial statement fraud is and how it can occur.

Financial Statement Fraud

- AICPA Center for Audit Quality (CAQ)
- “a material misrepresentation resulting from an intentional failure to report financial information in accordance with GAAP”

[Jeanne H. Yamamura]:

What is financial statement fraud? Per the Center for Audit Quality, financial statement fraud is “a material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles (GAAP).”

Common Fraud Schemes

- Fictitious or inflated revenues
- Expense understatement
- Asset overstatement
- Liability understatement
- Inappropriate reserves
- Improper classifications as “one time” expense
- Misapplication of GAAP
- Omitting or misrepresenting information
Common fraud schemes include: fictitious or inflated revenues, expense understatement, asset overstatement, liability understatement, inappropriate reserves, improper classification as “one-time” expense, misapplication of GAAP (or generally accepted accounting principles), and omitting or misrepresenting information.

Although major financial statement frauds have involved any or all of the above, the most widely used fraud technique involves enhancing revenues. This is likely due to the fact that when you are trying to increase net income, you can only decrease expenses so far. The only other item left is revenues. In recent years, we have seen many different versions of revenue enhancement schemes from bill and hold to round tripping to just making up completely fictitious revenues.

How do financial statement frauds occur? To understand how financial statement frauds occur, we start with the fraud triangle. Donald Cressey, a renowned criminologist, proposed the fraud triangle to identify why ordinary people commit fraud. The fraud triangle has 3 components – opportunity, motivation, and rationalization.

Cressey described motivation (incentive) as an unshareable pressure or need. These pressures can generally be divided into four types: Financial pressures include high bills or personal debt, personal financial losses, unexpected financial needs, greed, and living beyond one’s means. Financial pressures can be perceived or real. Vice pressures result from addictive habits such as gambling, drugs, and alcohol or costly adulterous relationships. Work-related pressures incorporate the need for payback against an employer or others. For example, feeling underpaid or unappreciated or being afraid of losing your job. The last category “other” is a catch all for
the miscellaneous other reasons that sometimes motivate fraud such as a desire to beat the system or the need to satisfy a financially demanding spouse. Financial and vice pressures are involved in approximately 95% of all frauds.

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*Opportunity*

- Perception of no detection or punishment
- Access to assets and information
- Allows fraud to be committed and concealed

[Picture Shown]

[Jeanne H. Yamamura]:

Opportunity opens the door. It provides an individual under pressure with the perception that a fraud can be committed without detection or punishment. It typically involves individuals who have access to assets and information – that access allows them to commit the fraud and then to conceal it.

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*Opportunity*

- Created by
  - Lack of internal controls
  - Lack of expertise
  - Lack of punishment
  - Lack of information
  - Lack of knowledge, caring or ability
  - Lack of audit trail

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Opportunity is created by:

Lack of internal controls: Lack of internal controls, in fact, is continually cited as the biggest factor contributing to frauds. Poor or missing internal controls invite people to commit fraud.

Lack of expertise to judge the quality of performance can enable frauds to occur because the victim must rely on the fraud perpetrator’s expertise. The victim can’t judge for him/herself whether or not the fraud perpetrator is telling the truth.

Lack of punishment for fraud perpetrators reduces concerns about being caught – even if you are caught, nothing is going to happen. It also reduces fraud reporting because even if you report the fraud, nothing happens.
Lack of information can enable frauds to occur because the victims don’t have access to information that would reveal the fraud.

Lack of knowledge, caring or ability on the part of victims enables fraud because the victim may not fully understand what is happening or those who should protect the victim are apathetic.

Lack of an audit trail contributes to fraud occurrence because there is no record of what has really happened. The documents may be destroyed and the transaction may be recorded incorrectly or not recorded at all.

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**Rationalization**

- **Justification**
  - **Common rationalizations:**
    - I’m just borrowing the money. I will pay it back.
    - I deserve the money. The company doesn’t pay me enough for what I do.
    - It’s for a good cause.
    - Nobody will be hurt.
    - It’s just this one time.
    - I have to do it to keep everyone from finding out about my other problems.

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Rationalization is the final piece of the fraud picture. It is the reason that fraud perpetrators give to themselves to justify committing the fraud. Common rationalizations include the following:

- I’m just borrowing the money. I will pay it back.
- I deserve the money. The company doesn’t pay me enough for what I do.
- It’s for a good cause.
- Nobody will be hurt.
- It’s just this one time.
- I have to do it to keep everyone from finding out about my other problems.

The hardest fraud to commit is the first one. After that, since no one caught the fraud, it gets easier and easier. In fact, longtime frauds are often caught because the fraud perpetrator stops being careful and covering up.

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**Fraud Triangle and Financial Statement Fraud**

- **Motivation (pressure)**
  - Personal gain
  - Need to meet short-term financial expectations
  - Desire to hide bad news
Now let’s go back and look at financial statement frauds through the lens of the fraud triangle.

The CAQ identified the top three pressures for financial statement fraud as: 1) personal gain in the form of performance bonuses or stock-based compensation, for example; 2) a need to meet short-term financial expectations; and 3) desire to hide bad news.

Most financial statement frauds are committed by senior management. Senior management has a unique opportunity to commit fraud because of their ability to override controls and to pressure employees to participate. This is a picture of “Chainsaw” Al Dunlap who was supposed to be this fabulous turnaround artist. In fact, as CEO of Sunbeam, he orchestrated a massive accounting fraud to make it look like he had turned the company around.

Rationalization can occur in several ways when financial statement fraud is committed. It may be presented as “just a little adjustment” only needed this one time. It could also be justified as necessary for the greater good in order to save the company. This is a picture of Betty Vinson of World Com who pleaded guilty to securities fraud in 2002 after making adjustments to boost net income. The first entry that she made was an adjustment to boost income by 828 Million in mid-2000. When she was asked to do it she was told that it was needed to save the company and she
only needed to do it one time. After having done that first adjustment, she then went on to make another 17 adjustments. Thus, he prison sentence.

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The Auditors

- Auditors should find fraud
- Why they don’t
  - Objective of audit
  - Sampling
  - Senior management

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Perhaps you are thinking that the external auditors are responsible for and should be able to detect financial statement fraud. After all, they audit the financial statements and issue an opinion on them.

Why auditors don’t find fraud:

The objective of the audit is not to find fraud – it is to issue an opinion as to whether or not the financial statements are presented in accordance with GAAP.

Auditors don’t look at every transaction. They utilize sampling techniques and just look at a few of the thousands of transactions that have occurred during the year. They rely on the internal control system to ensure that the bulk of the transactions were recorded properly.

Financial statement fraud is typically committed by senior management. Senior management can override the internal control system.

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Preventing Financial Statement Fraud

[Picture shown]

- Three key areas
  - Strong tone at the top
  - Skeptical mindset
  - Strong communication
Jeanne H. Yamamura:

Financial reporting fraud is expensive and damaging to organizations and its occurrence is on the rise. Difficult economic times combined with pressure to perform have created a “perfect storm” in which all of the fraud triangle factors are present.

The Center for Audit Quality identified three areas that can help organizations to reduce their risk of financial statement fraud: The first and most important is a strong tone at the top. An organization’s ethical culture is created and reinforced by senior management. “Do as I do” sends a message throughout the entire organization. A skeptical mindset. Information is validated through other sources, questions are asked, and inconsistencies are investigated. And then finally, strong communication. Multiple players take part in the financial reporting process. They must communicate frequently and openly to share information and enable viewing the company as a whole.