FINANCIAL REPORTING FRAUD:
GRABBING STUDENT ATTENTION WITH HEADLINES

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ABSTRACT

Business and accounting students love to hear stories of business activities that make the headlines. To grab students' attention, get them interested in accounting, and help them understand financial reporting, discuss the following fraudulent financial reporting cases in class; and if you really want to enliven the presentations, use some props, talk about how the fraudsters were caught, and provide results of criminal outcomes. Paraphrase the following narrative and you are well on your way to exciting classroom presentations about financial reporting fraud. If you more interactive learning in your classroom, assign a case to a student group and have them role play!

BACKGROUND

As long as there have been financial reports, there has been financial reporting fraud. The individuals, companies, and specific actions change, but the motives and concepts applied are incredibly consistent. While the majority of corporate managers are honest, hard-working, and law-abiding, the temptation exists to commit fraud. Therefore, accountants, as corporate financial watchdogs, need to understand fraudulent financial reporting and how it is committed.

Most fraudulent financial reporting can be divided into three categories based on method: bogus or early revenue, expenses recorded as assets, and hiding liabilities and losses. This paper begins with a review of the fraud triangle, provides examples of fraud in each of the above categories, and concludes with a discussion of fraudster actions – some innovative and some of questionable intelligence.

The Fraud Triangle requires three components: Opportunity, Perceived Need, and Rationalization. Fraud often starts when an individual sees the opportunity or a weakness in the system. Remember Richard Pryor as Gus Gorman in Superman III? As a late-bloomer, IT specialist Gorman figured out how to have the partial pennies on all his company's employees' paychecks sent to his account. The company executives realize the fraud is going on but say they cannot determine who is doing it (only in the movies). My point here is Gorman's epiphany in the movie when he realizes the financial opportunity in front of him.

The second point of the Fraud Triangle is 'Perceived' Need. I include the adjective 'perceived' because when most of us think of need we think of the basic needs - food, shelter, and clothing. For the fraudsters in the following examples the need was wealth and desire for a more extravagant life style. For example, Cathy Gieseker's $27.4 million fraud[1] allowed her to buy numerous large trucks, ATVs, SUVs and show pigs (yes, show pigs! Pigs farmers show in competition at state fairs). Farmers who Gieseker defrauded received only about 2% of their money back. Clearly, Gieseker's need was not for life's necessities.

The third point of the Fraud Triangle is rationalization. Rationalization for financial reporting fraud goes something like this: 'The company doesn't pay me what I am worth.' 'They owe me.' 'It's a large company so my little bit doesn't hurt.' 'I'm helping others keep their

[1] Cathy Gieseker used a pyramid scheme to conduct the largest agricultural fraud in Missouri history.

jobs!' In some cases, the rationalization is more about exercising control. World Com's Bernard Ebbers drove upper management to develop fraudulent financial reports for the company Ebbers founded. Why? Ebbers had a strong drive to control and grow his company.

Fraud can generally be divided into two categories: 'Fraud of the Firm' and 'Fraud for the Firm.' Fraud of the Firm (think of Gus Gorman's activity in Superman III or Johnny Cash's 'One Piece at a Time') results in direct theft of firm assets by an employee or employees. Fraud for the Firm is the manipulation of firm financial statements (mainly the income statement and balance sheet) to portray the firm in a more favorable light. In both frauds, the goal is the same - financial gain for the fraudster. The gain is direct (e.g. cash) with Fraud of the Firm. The gain is indirect with Fraud for the Firm, because the direct effect is "improved" financial reports which then provide a financial return (e.g. higher stock price, increased bonus) to the fraudster. This presentation focuses on Fraud for the Firm, or financial statement manipulation.

FRAUDULENT FINANCIAL REPORTING METHODS

There are numerous methods to commit fraud for the firm, but most fall into three (possibly overlapping) categories.

1. Record bogus (or early) revenue
2. Record expenses as assets
3. Hide liabilities (and losses)

We discuss these three categories below.

Bogus or Early Revenue

Managers at Miniscribe Corporation were experts at recording bogus revenue. Miniscribe made computer components when PCs first became hot commodities in the 1980's. When market analysts predicted revenue growth – Miniscribe responded by having employees work overtime to ship more products (otherwise failing to meet revenue projections would decrease the firm's stock price and corresponding management compensation). This worked several quarters until they depleted their order backlog. Still, Miniscribe continued making extra components and shipping these products to a warehouse to be held for customer pickup under an accounting policy known as 'bill and hold".[2] At about that time, corporate management noticed that bricks they used for home building were the approximate size of the computer components. Miniscribe bought bricks, packaged them like computer components, shipped the bricks to the warehouse, and recorded 'revenue' on the brick shipments. Suggestion - An accounting instructor might bring in several identical boxes, some with computer components and one or two with bogus material filler of the same size and weight. Ask the students how many inventory items there are. Some students will want to open all the boxes, but some will open only a couple as examples. Talk with your students about the value of skepticism as an accountant or auditor.

Some fraud is to be admired for its simplicity. To prove its reported revenue, Service Corporation management provided auditors with a letter from a primary customer that read in

[2] Bill and hold still exists under the new revenue recognition standard. This would be a good class opening for discussing revenue recognition.

part: “We will now buy inventory from your company.” Later investigation revealed Service Corporation management, using white-out, had written over the ‘t’ in ‘not’ to make ‘now.’ Suggestion - Type a letter on fake letterhead with the above line as part of the full letter. White out the ‘t’ for an ‘n’ and see how many students can catch the change when you pass the letter around in class. Talk with students about having the proper support for revenue recognition.

ZZZ Best was in the restoration business. To prove to auditors that business was thriving and revenue was up, ZZZ Best developed an elaborate scheme. The firm rented a floor in an office building, furnished the floor, installed bogus company names, and logos, then promptly destroyed the entire floor. When the auditors showed up, ZZZ Best employees were busily ‘restoring’ the ‘customers’ facility. Later investigation revealed that ZZZ Best’s restoration revenue exceeded all restoration revenue in the U.S. that year. Suggestion – Talk with students about how accountants, as part of the management team and not just number crunchers, must have strong analytical skills.

Record Expenses as Assets

Recording expenses as assets increases assets on the balance sheet and increases net income on the income statement. Bernard Ebbers was a master at this technique, although he denied accounting knowledge in court. World Com recorded $3.8 B of communication line expenses as assets over seven years. Bernard Ebbers ‘persuaded’ his upper management to facilitate this financial reporting fraud, many of whom turned against him at trial.

A common method to convert expenses to assets, and thus increase net income, is to overstate inventory. Anthon DeAngelis, the Salad Oil King, was gifted at converting expenses into assets. His huge vats in New Jersey were reported as full of salad oil, which the auditors examined and signed off on. The auditors were duped. DeAngelis noticed the auditors using a tube only checked the quality of the top four feet of his vats. DeAngelis’ vats actually only contained five feet of salad oil. The rest was water. To compound his fraud, when the auditors moved from one vat to another, DeAngelis pumped that same oil to the next vat! Suggestion - As a prop for this exhibit use opaque water bottles. Show students olive oil in the water bottles and work with them on how to calculate volume, as the auditors would need to do. Then walk with the students on the fallacy of that calculation, because only the top layer of the water bottle was oil. Most of the water bottle was filled with water.

Hide Liabilities and Losses

The third category of financial reporting fraud is hiding liabilities as losses. Enron was a spider web of hidden liabilities and losses. Enron management set up over 3,000 Special Purpose Entities (SPEs) – business operations that were not, by overly bending financial operating rules, financially reported with Enron. Using Enron stock as collateral these SPEs borrowed from banks and then paid this money to Enron, calling the payments dividends and interest. The SPEs took huge losses (as they were not actually doing anything productive), but the SPEs’ loans and losses did not appear on Enron’s financial statements. Enron’s financial statements showed dividends and interest from its (SPE) investments!

Olympus is one of the largest firms in Japan. With the economic collapse of 2008, Olympus had a $4 billion loss to recognize on an investment. Incredibly, Olympus found a buyer willing to pay full cost for this investment, thus allowing Enron to avoid recognizing the loss. Olympus later bought this firm for the full cost of the investment, but since the investment was no longer worth the full original cost, Olympus recorded the difference as goodwill. The Japanese government, however, required Olympus to recognize the loss when the government determined the buyer was an SPE set up by Olympus to avoid recognizing the loss. Suggestion - For both the Enron and Olympus examples, diagrams of the business arrangements can be very useful. You might, jokingly, use the Tokyo subway map initially and explain that this is a map of Enron's investment activity.

END GAMES

These examples show an incredible understanding of financial reporting law by fraudsters and the ability to thwart or circumvent these laws. The individuals who set up these financial reporting frauds had the intellectual acumen to understand and circumvent financial reporting rules. What they often lacked, however, was the foresight to consider the direction and end game of their fraud. Consider several examples.

Miniscribe management, who were shipping bricks instead of computer components, determined that since bricks take less labor to produce than computer components they could save a few dollars by laying off employees. Did Miniscribe Management think the employees did not understand fraud? Those unemployed called the State Attorney General.

With inventory manipulation or bogus revenue schemes, to continue showing increased revenues, bogus inventory levels or revenues must continue to rise, but those levels will eventually get out of hand. For example, investigators later determined that DeAngelis' financial reports reported more salad oil in his vats than existed in the United States on that date and that ZZZ Best reported more restoration revenue than occurred in the United States that year. Suggestion - Either of these cases would be a great opportunity to show accounting and business students that accountants and auditors must be good at analytics and common sense, and not just blindly crunch numbers.

SUMMARY

Case studies of financial reporting fraud provide an excellent opportunity to catch students' attention and as a starting point for further discussion on the topics. The cases mentioned above are examples instructors can use to explain accounting and identify what the accountants or auditors should have done to catch the financial reporting fraud. These cases also make excellent group projects for students for role play. I hope you enjoy presenting these and other cases in your classes as much as I do.