



ESSENTIAL ISSUES IN AUDITING – A PRACTICAL APPROACH

Common Accounting Falsifications and Identifying them

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GAMAX Ltd

Introduction

Background

- MBA (For Executives)
- BCom. (Hons)
- CISA
- CPAK
- FCCA

- Over 16 years experience in **Risk Management, Audit/ Consultancy, Internal Controls, IT Audits and Corporate Governance** {PwC, PKF, TSGL, Zain, CCK}
- Associate Consultant/Facilitator for KCA University, CCG, ICPAK, IIA, iCPAR, G-Optimized etc



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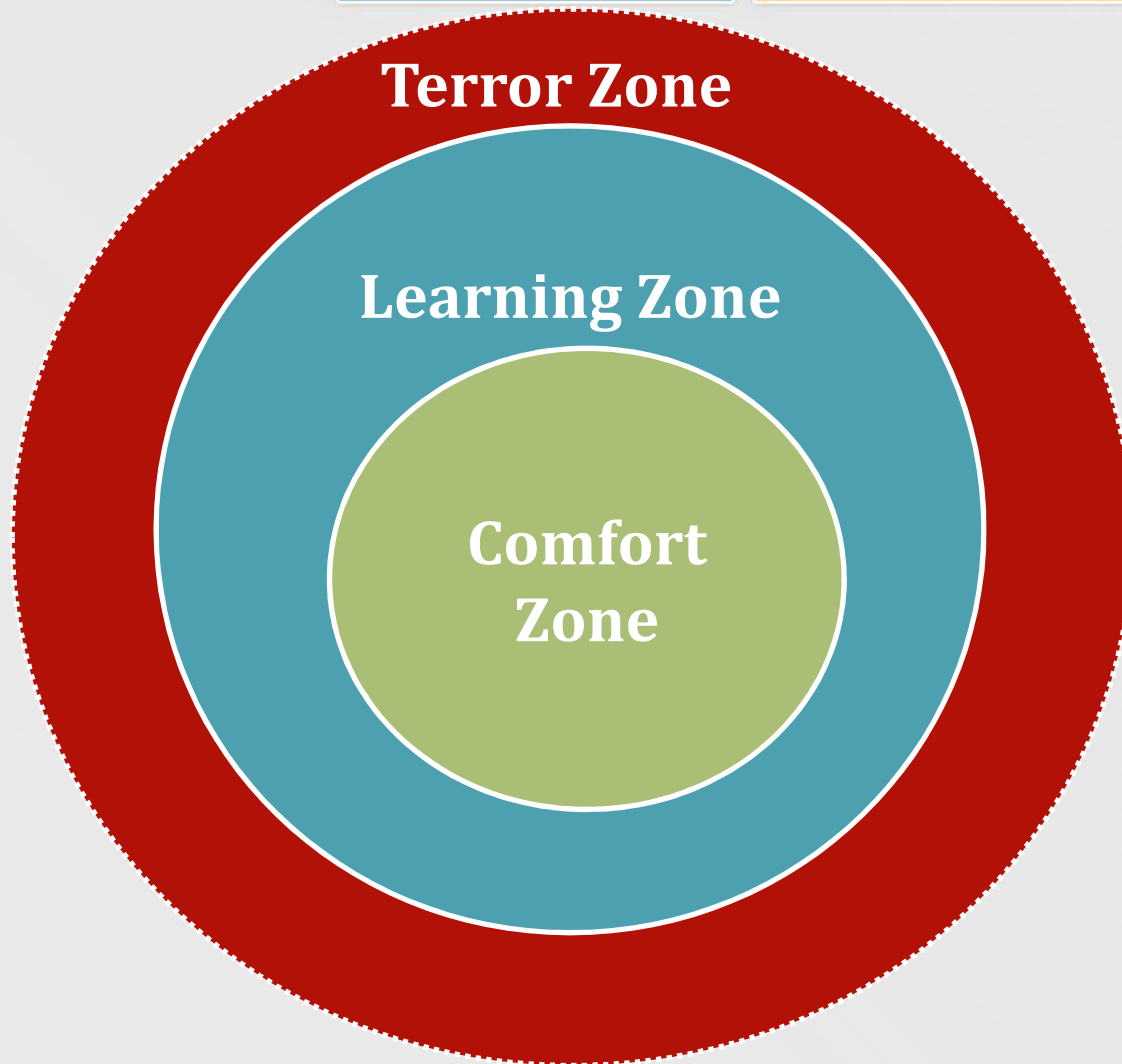
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The “Right of Choice” in Accounting

- There are **four factors (or actions)** that ensure **a genuine and fair view** of a company’s financial situation.
- They are determined by the following considerations:
 - ☐ approach (what should be measured);
 - ☐ measurement (how to measure);
 - ☐ disclosure (which information to disclose);
 - ☐ presentation (how to present information).



Distinguishing between errors and Fraud

- **Errors**

- Inadvertently taking an expense to the wrong account (e.g. advertising to amortization expense)
- Booking an unreasonable accounting estimate for allowance for bad debt expense (e.g. allowance for bad debts)
- Incorrectly applying accounting principles (*assets at cost vs. market value*)

- **Fraud** (*Purposefully producing deceptive data*)

- **Misstatements due to fraudulent financial reporting:-** {management or owners are usually involved, and the fraud is facilitated by overriding internal controls}.
- **Misstatements because of the misappropriation of assets:** -by non-management employees.



Essence of Creativity in Accounting



- Has **more than one interpretation** and different understandings, and its negative, but also certain positive aspects may be identified.
- The creative approach to business operations and their measurement was first developed in advanced market economies, in which accounting regulations and other legal provisions left the decision of the choice of accounting principles to corporations themselves (*Griffiths, 1986, p. 5*).
- The concept of “**creative accounting**” is often used alongside such concepts as **income smoothing**, **earnings management**, or **cosmetic accounting**.

Essence of Creativity in Accounting



- ...**negativity** lead to a definition of creative accounting as a negative practice generating various threats to the objectivity of disclosed financial data. .
- **+VE definition** is included in the British Dictionary of Accounting (2001, p. 69) - perceived as using business data in such a manner that the company's condition appears to be better than it really is, in order to attract potential business partners or for whatever other important reason.
- Applying permissible practices and accounting solutions which, although legal, may mislead banks, investors or shareholders about the company's profitability and financial liquidity, is also an element of creative accounting.

Essence of Creativity in Accounting



- **Creativity** so understood is grounded on the existence of the “**right of choice**” in accounting, allowing to present the company’s image in a manner that complies with the view desired by the management.
 - i. Satisfy legal regulations;
 - ii. Meet expectations of investors and stakeholders;
 - iii. Stick to certain limits delineated by legal regulations and ethical business principles.
 - iv. May not, however, infringe upon the principles of presenting a true and fair view.

Aggressive Accounting

- Means manipulation with financial data in order to mislead and confuse the recipients of information.
- **Does not seek** to use the possibilities available in accounting creatively so that the true picture of a company's condition is attractively presented.
- Also means acting contrary to the binding regulations and laws, or intentional misinterpretation of those laws performed to present the reality in a better light, rather than to give a fair and true picture of the state of affairs.
- May be focused, inter alia, on **artificial inflation of profits** and accomplishments in order to enhance an entity's position and increase its financial result upon which the company's goodwill is calculated.



Essence of Fraudulent Accounting

- **Aggressive accounting** involves falsifying records in accounts books and presenting untrue data in financial reports.
- There is no mention of creative or aggressive accounting in the wording of standard No. 240; instead the terms fraud and error have been used (IFRS, 2002).
- **Error is understood as an unintentional mistake** in the financial statements, caused, inter alia, by:
 - errors arisen when collecting and processing the data subsequently entered in the books or financial statements;
 - omissions or wrong interpretation of facts;
 - inappropriate application of accounting principles for valuation, classification, presentation, or disclosure of information.

Essence of Fraudulent Accounting

- According to the IFRS, **fraud is an intentional act** undertaken by one or more directors, members of the management, employees or any third party that results in irregularities that arise in the financial reports or annual accounts.
- These standards differentiate between **five types of fraud**:
 1. Manipulation, falsification, or alteration of the data or documents;
 2. Embezzlement or misappropriation of assets;
 3. Exclusion or omission of entering the effects of a transaction in accounts or documents;
 4. Registration of apparent transactions;
 5. Wrong application of the accounting policies.

A condition necessary to establish that a fraud has been committed is a loss suffered by the injured party.

Essence of Fraudulent Accounting

- To establish a certain activity as fraudulent, the **four following events** must be established:
 - i. material falsification of information;
 - ii. awareness of a fraud committed at the moment of submission of financial statements;
 - iii. reliance on falsified information;
 - iv. loss as an effect of a fraud.



Relationship between.....

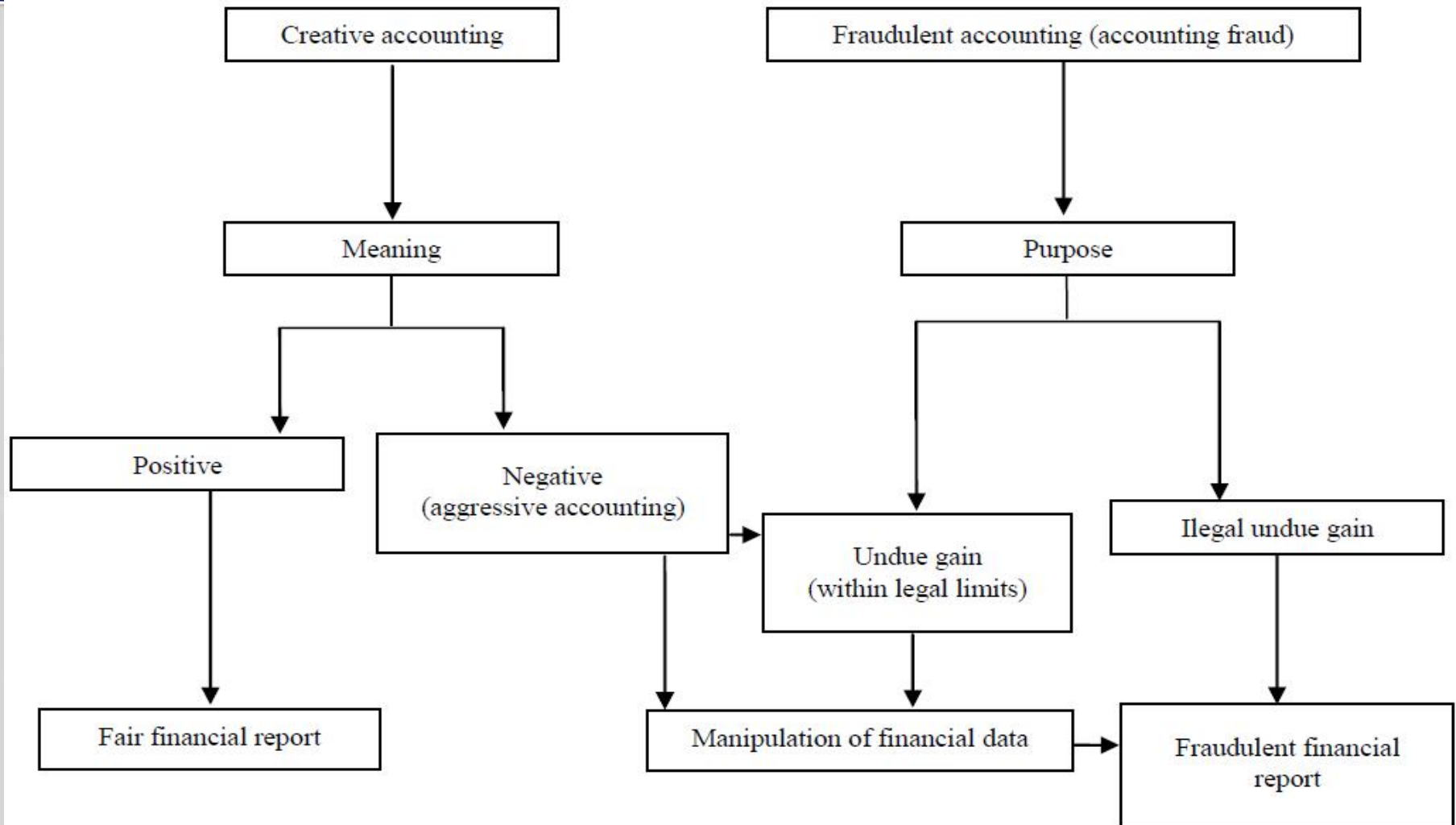


Figure 1. Relationships between creative accounting and aggressive accounting with fraudulent accounting. Source: Own work based on Gierusz and Martyniuk (2007, p. 67).

Falsification of Information

- Shilit (1993) divided all possible ways in which information and data in financial reporting may be fraudulently distorted and distinguished between the following fraudulent practices:
 - (1) **premature revenue recognition;**
 - (2) **recording fictitious revenues;**
 - (3) **boosting income with one-time-gains;**
 - (4) **forwarding current costs to future periods;**
 - (5) **failure or omission to disclose in books all liabilities;**
 - (6) **forwarding current income to later periods;**
 - (7) **recording future costs in current periods**



The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

Waste Management Scandal (1998)

- **Company:** Houston-based publicly traded waste management company
- **What happened:** Reported \$1.7 billion in fake earnings.
- **Main players:** Founder/CEO/Chairman Dean L. Buntrock and other top executives; Arthur Andersen Company (auditors)
- **How they did it:** The company allegedly falsely increased the depreciation time length for their property, plant and equipment on the balance sheets.
- **How they got caught:** A new CEO and management team went through the books.
- **Penalties:** Settled a shareholder class-action suit for \$457 million. SEC fined Arthur Andersen \$7 million.

Enron Scandal (2001)

- **Company:** Houston-based commodities, energy and service corporation
- **What happened:** Shareholders lost \$74 billion, thousands of employees and investors lost their retirement accounts, and many employees lost their jobs.
- **Main players:** CEO Jeff Skilling and former CEO Ken Lay.
- **How they did it:** Kept huge debts off balance sheets.
- **How they got caught:** Turned in by internal whistleblower Sherron Watkins; high stock prices fueled external suspicions.
- **Penalties:** Lay died before serving time; Skilling got 24 years in prison. The company filed for bankruptcy. Arthur Andersen was found guilty of fudging Enron's accounts.

The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

WorldCom Scandal (2002)

- **Company:** Telecommunications company; now MCI, Inc.
- **What happened:** Inflated assets by as much as \$11 billion, leading to 30,000 lost jobs and \$180 billion in losses for investors.
- **Main player:** CEO Bernie Ebbers
- **How he did it:** Underreported line costs by capitalizing rather than expensing and inflated revenues with fake accounting entries.
- **How he got caught:** WorldCom's internal auditing department uncovered \$3.8 billion of fraud.
- **Penalties:** CFO was fired, controller resigned, and the company filed for bankruptcy. Ebbers sentenced to 25 years for fraud, conspiracy and filing false documents with regulators.



The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

Tyco Scandal (2002)

- **Company:** New Jersey-based blue-chip Swiss security systems.
- **What happened:** CEO and CFO stole \$150 million and inflated company income by \$500 million.
- **Main players:** CEO Dennis Kozlowski and former CFO Mark Swartz.
- **How they did it:** Siphoned money through unapproved loans and fraudulent stock sales. Money was smuggled out of company disguised as executive bonuses or benefits.
- **How they got caught:** SEC and Manhattan D.A. investigations uncovered questionable accounting practices, including large loans made to Kozlowski that were then forgiven.
- **Penalties:** Kozlowski and Swartz were sentenced to 8-25 years in prison. A class-action lawsuit forced Tyco to pay \$2.92 billion to investors.

HealthSouth Scandal (2003)

- **Company:** Largest publicly traded health care company in the U.S.
- **What happened:** Earnings numbers were allegedly inflated \$1.4 billion to meet stockholder expectations.
- **Main player:** CEO Richard Scrushy.
- **How he did it:** Allegedly told underlings to make up numbers and transactions from 1996-2003.
- **How he got caught:** Sold \$75 million in stock a day before the company posted a huge loss, triggering SEC suspicions.
- **Penalties:** Scrushy was acquitted of all 36 counts of accounting fraud, but convicted of bribing the governor of Alabama, leading to a 7-year prison sentence.

The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

Freddie Mac (2003)

- **Company:** Federally backed mortgage-financing giant.
- **What happened:** \$5 billion in earnings were misstated.
- **Main players:** President/COO David Glenn, Chairman/CEO Leland Brendsel, ex-CFO Vaughn Clarke, former senior VPs Robert Dean and Nazir Dossani.
- **How they did it:** Intentionally misstated and understated earnings on the books.
- **How they got caught:** An SEC investigation.
- **Penalties:** \$125 million in fines and the firing of Glenn, Clarke and Brendsel.

American International Group (AIG) Scandal (2005)

- Company: Multinational insurance corporation.
- What happened: Massive accounting fraud to the tune of \$3.9 billion was alleged, along with bid-rigging and stock price manipulation.
- **Main player:** CEO Hank Greenberg.
- How he did it: Allegedly booked loans as revenue, steered clients to insurers with whom AIG had payoff agreements, and told traders to inflate AIG stock price.
- How he got caught: SEC regulator investigations, possibly tipped off by a whistleblower.
- **Penalties: Settled with the SEC for \$10 million in 2003 and \$1.64 billion in 2006, with a Louisiana pension fund for \$115 million, and with 3 Ohio pension funds for \$725 million. Greenberg was fired, but has faced no criminal charges.**

The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

Lehman Brothers Scandal (2008)

- **Company:** Global financial services firm.
- **What happened:** Hid over \$50 billion in loans disguised as sales.
- **Main players:** Lehman executives and the company's auditors, Ernst & Young.
- **How they did it:** Allegedly sold toxic assets to Cayman Island banks with the understanding that they would be bought back eventually. Created the impression Lehman had \$50 billion more cash and \$50 billion less in toxic assets than it really did.
- **How they got caught:** Went bankrupt.
- **Penalties:** Forced into the largest bankruptcy in U.S. history. SEC didn't prosecute due to lack of evidence.

Bernie Madoff Scandal (2008)

- **Company:** Bernard L. Madoff Investment Securities LLC was a Wall Street investment firm founded by Madoff.
- **What happened:** Tricked investors out of \$64.8 billion through the largest Ponzi scheme in history.
- **Main players:** Bernie Madoff, his accountant, David Frierling, and Frank DiPascalli.
- **How they did it:** Investors were paid returns out of their own money or that of other investors rather than from profits.
- **How they got caught:** Madoff told his sons about his scheme and they reported him to the SEC. He was arrested the next day.
- **Penalties:** 150 years in prison for Madoff + \$170 billion restitution. Prison time for Frierling and DiPascalli.

The Big Issues - Global and Local

The 10 Worst Corporate Accounting Scandals of All Time

Satyam Scandal (2009)

- Company: Indian IT services and back-office accounting firm.
- **What happened:** Falsely boosted revenue by \$1.5 billion.
- **Main player:** Founder/Chairman Ramalinga Raju.
- How he did it: Falsified revenues, margins and cash balances to the tune of 50 billion rupees.
- **How he got caught:** Admitted the fraud in a letter to the company's board of directors.
- **Penalties:** Raju and his brother charged with breach of trust, conspiracy, cheating and falsification of records. Released after the Central Bureau of Investigation failed to file charges on time.
- **Fun fact:** In 2011 Ramalinga Raju's wife published a book of his existentialist, free-verse poetry.

Toshiba boss quits over £780m accounting scandal (2015)

- Hisao Tanaka stands down at Japanese electronics firm
- Toshiba's boss has quit the Japanese conglomerate over a 152bn yen (£780m) accounting scandal that the government said threatened to undermine investors' confidence in the country.
- Norio Sasaki, who is vice-chairman, and Atsutoshi Nishida, who is an adviser to the company, will also leave.
- Toshiba overstated its operating profits over several years in accounting irregularities involving its top management, an independent panel of accountants and lawyers said on Monday.

The Big Issues - Global and Local

Ernst & Young cleared in EAPCC accounts scandal (2013)

- The State and the NSSF -claimed that the cement maker's financial statements had been doctored.
- E&Y, who were auditors on the spot over their possible involvement in covering up accounting irregularities.
- E&Y had been hired by KENAO to audit the cement manufacturer's books on its behalf.
- The CMA has said Ernst & Young was not involved in alleged manipulation of accounts EAPCC.

Deloitte fights back claims of abetting accounting fraud (2013)

- ICPAK cleared Deloitte against claims of abetting fraud at **Mumias Sugar and CMC Holdings**.
- Yet to be cleared of allegations of abetting accounting fraud at **Tuskys** supermarkets.
- Four of the 5 biggest names in accounting have resolved class-action litigation or regulatory complaints in recent weeks, in pacts totaling more than **\$186 million** -- a costly few months for the firms as fallout from the accounting debacles of the late 1990s and early 2000s continues to spread.
- Expected to announce today it will pay a **\$50 million fine to settle SEC civil charges** that it failed to prevent massive fraud at cable company Adelphia Communications Corp.

The Big Issues - Global and Local

- **Arthur Andersen LLP** agreed to a **\$65 million** settlement in a class-action suit by investors in WorldCom Inc. over losses from stocks and bonds of the once-highflying telecommunications company now known as MCI Inc.
- These follow a \$22.4 million settlement the SEC reached last week with KPMG LLP related to its audits of Xerox Corp. **XXR 1.04** % from 1997 through 2000, and a \$48 million settlement by PwC LLP last month to end class-action litigation over its audit of Safety-Kleen Corp., an industrial-waste-services company that filed for bankruptcy-court protection in 2000.
- In January (EY) agreed to pay \$84 million to settle a lawsuit in Federal District Court in Boston over its audit work more than a decade ago for the defunct Bank of New England Corp.

A new EY survey shows Kenyan firms over-report their financial performance to meet rising targets and please ever demanding shareholders.



The Big Issues - Global and Local

- In a global survey in which 100 Kenyan firms participated, the findings by the audit firm show 53% of managers believed their companies over-report their financial performance.
- The EY findings, governance experts said, are raising questions over the ability of local boards, regulators and auditors to police management and pick up “cooked” financial figures.



Deloitte

- EACC, in response to a complaint filed by cane farmers who allege that Deloitte connived with top executives of Mumias to conceal accounting flaws at the company, says the auditing firm should face civil action.
- MOCO, a group of about 75,000 cane farmers, has also accused the ICPAK, the accounting watchdog, of laxity in enforcing disciplinary action against Deloitte.
- This is the third time Deloitte is being accused of professional misconduct in handling books of accounts of firms here in Kenya.

Motivations

- The results of a study carried out in the 1980s (Albrecht, Howe, & Rommey, 1984, p. 14) indicate the following **motives** that perpetrators usually have:
 - i. living above means;
 - ii. personal indebtedness;
 - iii. family or environment pressures encouraging illegal behavior;
 - iv. close ties with clients or customers;
 - v. a feeling of not being paid well enough and out of proportion to their duties and responsibilities;
 - vi. addiction to gambling or other forms of hazard;
 - vii. a desire to break the security system in the organisation.

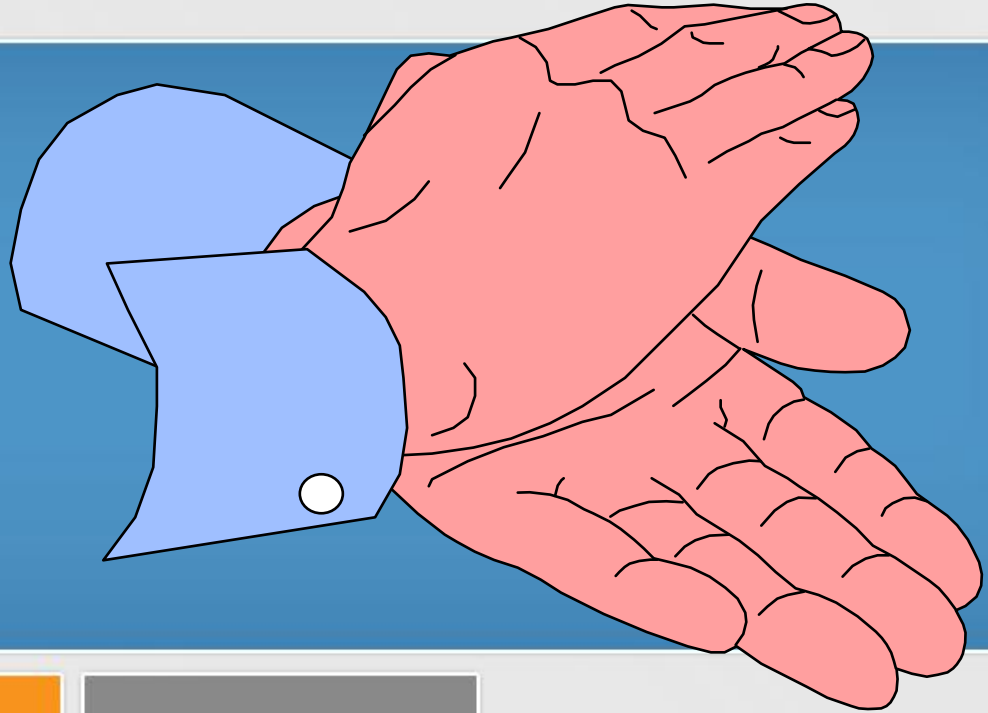


Practical Lessons



Group Discussions (5mins)

Thank You



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