Red Flags In Corporate Financial Reporting

Back to Basics - A Case Study Approach

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Investment is an act of faith

Dr. Manmohan Singh, 1991

Enron

- December 2, 2001
- First largest financial fiasco of the 21st century
- The largest bankruptcy then

Satyam

- January 7, 2009
- Shades of Enron
- Non existent cash of US$ 1 Bn +

"Those Who Forget History Are Doomed to Repeat It"

"The charm of history and its enigmatic lesson consist in the fact that, from age to age, nothing changes and yet everything is completely different".

September 28, 1998
The Numbers Game Speech ….

"The earnings management game runs counter to the very principles behind our markets strength and success. Increasingly, I have become concerned that the **motivation to meet Wall Street earnings expectations** may be overriding common sense business practices. **Too many corporate managers, auditors, and analysts** are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, **wishful thinking may be winning the day over faithful representation**"

SEC Chairman Arthur Levitt

…The Numbers Game Speech

- The Accounting Illusions

Big Bath Charges

Creative Acquisition Accounting

Cookie Jar Reserves

Materiality

Revenue recognition

Red Flags

Earnings Management

Adjust earnings to a desired outcome

Management incentive to serve their own best interests

Includes aggressive earnings management and fraud

- Revenue recognition
- Misreporting assets and liabilities
- Aggressive capitalization and amortization policies
- Creative income reporting

The Red Flags Boxes

Assets	Liabilities	Equity
Revenues	Operating costs	Income measures
Cash Flows	Disclosures	Other metrics

Red Flags

- Revenue growth and margins
- Earnings growth vs. Cash flow from operations
- Related party transactions
- Complex Transactions
- Days Sales Outstanding
- Sales & Expenses recorded at Corporate
- Transactions that pose difficult "substance over form" issues
- Days accounts payable

- Significant management estimates
- Accounting policies
- Tone at the Top
- Concentration of controls
- Role of Management, Board, Audit committees
- Complex organizational structure
- Tax structure
- Planned corporate actions
- Materiality arguments
- Violations

Materiality

- What could render a quantitatively small misstatement material?
- *masks a change in earnings or other trends*
- *hides a failure to meet analysts' consensus expectations*
- *changes a loss into income or vice versa*
- *concerns a segment or other portion that has been identified as playing a significant role in operations or profitability*
- *Affects compliance with regulatory requirements*
- *Affects compliance with loan covenants or other contractual requirements*
- *involves concealment of an unlawful transaction*
- *has the effect of increasing management's compensation*

(SEC)

Quarterly results

- The Cons
  - Short term focus
  - Led to management failures and accounting frauds
  - Management focus on stock price than creating shareholder value
  - Gaming the results
  - Management compensation based on quarterly results
  - CEO tenure and compensation tied to quarterly results
  - Guidance
  - Analyst estimates
  - "What can I get out of this gig?"
    or
    "What can I do to build a great company?"

Cost vs. Benefits

- Costs
  - Fraudulent financial information
  - Cost of raising future capital
- Benefits
  - Increase in share price
  - Managers and company and shareholders
- Cost Benefit for Entity vs. Cost Benefit for Managers

Case Studies

"Accounting fraud does tend to come in waves, and is discovered most often after a market collapse, since no one is interested in investigating much when stock prices are high and everyone's making big money"

Motives for the numbers game

Environmental context

Paramalat

- Italian dairy-foods giant
- $8.5 bn to $ 12 bn in vanished assets (2003)
- ~40% of assets ($ 4.9 Bn) were held by a subsidiary in a Bank of America Account in Cayman Island
- The Bank reported that no such account existed

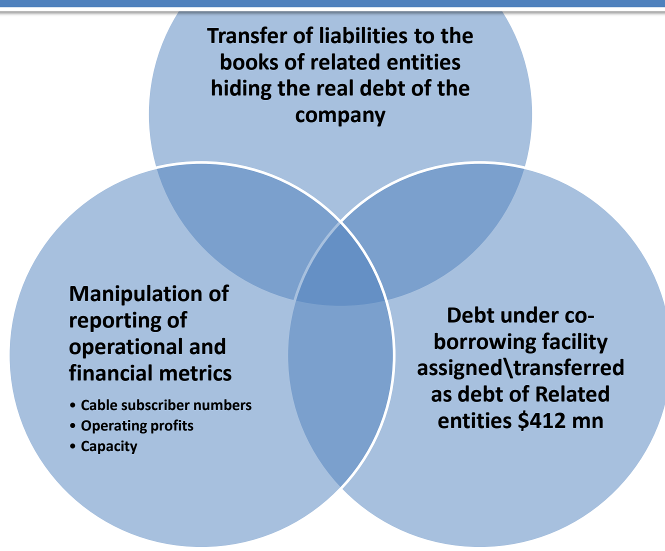
Satyam

- Listed in India and US
- Revenues of US$ 2 Bn
- Fourth largest Indian IT Company
- Established in mid 1980s
- Grown to 53,000 employees
- Confession – January 7th , 2009
- Inflated revenues
- Hole in the balance sheet Non-existent cash & bank balances $ I bn
- Overstated Sundry Debtors by $ 100 million
- Operating margin shown high at 24% in Q2 (Sept 2008) as against 3% real profit margin
- Such manipulation done in earlier years(6 yrs-$ 1.2 Bn)
- Increased costs to justify higher level of operations
- Attempt to merge Son's Company 'Maytas' with huge land Bank to bridge the gap failed
- Ambitious growth drive
- Audit failure- example., External confirmations of Bank balances not properly done
- ESOPs issued to those who prepared fake bills
- Excessive interest in maintaining stock prices

Adelphia Communications

- 1972: Adelphia was incorporated
- Growth Strategy
- 1986 : IPO
- Family owned
- Committed to community
- Financial Structure – High operating and financial leverage
- A troubled 1990s for the cable industry,
- March 27, 2002 – Analyst meet
- The fall – announcement of additional $ 3 Bn debt
- The Fraud

Adelphia Communications



Worldcom

- Led the telecom industry into profitability in the 90's
- In a low margins environment Worldcom decided growth=survival
- Acquisition strategy – completed many mega deals
- 1999 : revenue growth halted; impact on stock price
- Was U.S.' 2^{nd} largest long-distance operator in 1998 and 2002
- Had over 20 million customers in 2002
- Borrowed $366 million to cover losses on stock which was not repaid
- Secured loans from WorldCom to fund personal investments including a $100 million Canada ranch, $658 million in Mississippi timberlands and a $14 million Georgia shipyard
- Netted $140 million from stock sales
- CEO Bernard Ebbers resigned from WorldCom on April 30, 2002
- Scott Sullivan, CFO
- Directed staff to make false accounting entries
- Personally made false and misleading public statements regarding finances
- Netted $45 million from stock sales

Worldcom

"Line Costs"

From 1998-2000, WorldCom reduced reserve accounts held to cover liabilities of acquired companies`

- WorldCom added $2.8 billion to the revenue line from these reserves

Reserves didn't cut it; An e-mail was sent in December 2000 to a division in Texas directing misclassification of expenses.

CFO told key staff members to mark operating costs as long-term investments.

- To the tune of $3.85 billion
- Opex to capex

Huge losses turned into enormous profits.

- $1.38 billion in net income in 2001
- Inflated the company's value in its assets

Enron

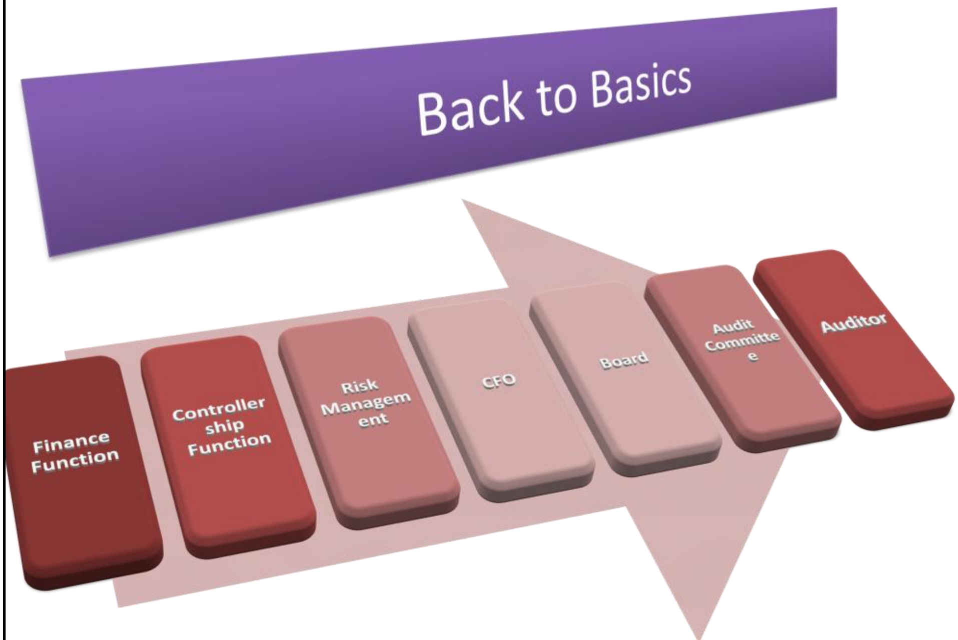
- Failure to consolidate dependent SPEs
- Failure to disclose related party relationships of SPEs
- Overstatement of earnings from mark-to market
- Quality of reports was poor due to above
- Earnings management
- Lack of controls and tone at the top

Enron

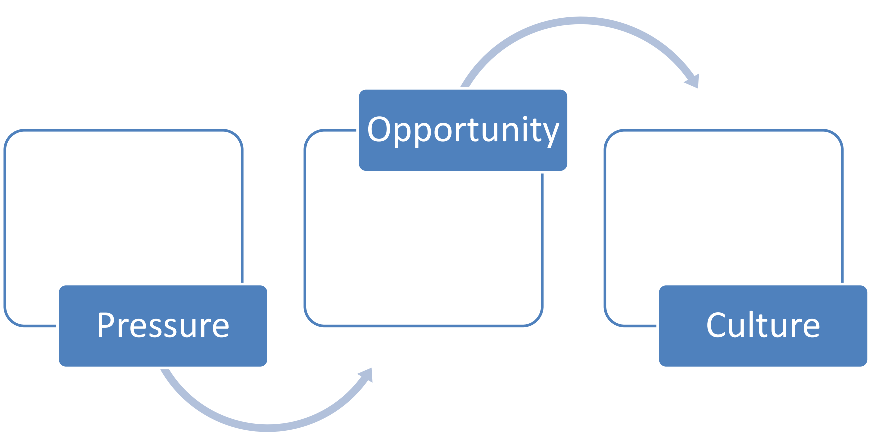
- Recorded anticipated revenue immediately
- Getting deeply in debt
- Treadmill of: keep growing, book bigger deals
- Special Purpose Entity (SPE)
  - 3% ownership to keep off books
  - Borrows money from bank, backed by Enron stock
  - Enron sells asset to SPE and gets loan
  - Money
- Arrangements hid debt
- No transfer of risk to the SPE

Profiteering

Enron	Tyco	Adelphia Communications
• Skilling (CEO) received approximately US$200 million from sale of Enron stock options, netting over US$89 million in profit and was paid more than US$14 million in salary and bonuses • Lay (Chairman) received US$300 million from sale of Enron stock options, netting over US$217 million profit and paid more than US$19 million in salary and bonuses • Richard Causey (Chairman)received more than US$14 million from sale of Enron stock and options, netting over US$5 million profit and paid more than US$4 million in salary and bonuses	• Compensation amounting to millions paid to executive officers, loans extended to executive officers which were later forgiven, related party transactions, certain executives utilizing Tyco's corporate resources to fund personal ventures and property acquisitions, to increase their own personal wealth	• Routinely used Adelphia's corporate aircraft for their personal affairs, without reimbursement to Adelphia, used approx US$252,157,176 in Adelphia funds to pay margin calls against loans to the Rigas family



Reigning in Earnings Management

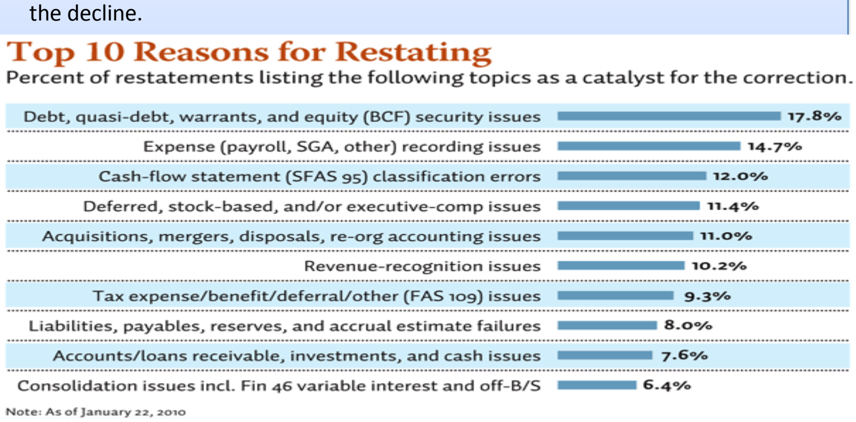


The Analysis Strategy

- Qualitative
- Horizontal\Vertical
- Financials
- Multi period and industry data
- Base year and growth
- Stock market related
- Corporate governance
- Auditing
- Executive compensation
- Insider Trading
- Risk Management

Restatements

- The number of financial restatements fell in 2009 for the third year in a row, according to a new report. The report, by research firm Audit Analytics, posits that the Sarbanes-Oxley Act and the Securities and Exchange Commission are behind the decline.



IFRS

- Concept
- Earnings management

Thank You