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How Financial Statement Fraud is Committed: Five Mini Case Studies

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Financial statement fraud is not as prevalent or publicized as embezzlement, but as certified fraud examiner Anne Eberhardt points out, the losses are much higher. She offers five mini case studies of fraud, including some perpetuated by well-known companies, as a cautionary tale. If something seems too good to be true, it usually is.

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Bernie Madoff didn't do anything but take the investors' money. Everyone understands that. But that's not a complete picture of the fraud he committed. Madoff's 17th floor employees painstakingly constructed false books, records and statements that were sent to investors, showing their investment value growing steadily. Madoff's visible business was handled on the 18th and 19th floors. People didn't visit the 17th floor, where the false records were stashed.

Most people have trouble picturing financial statement fraud. Not many people go to jail for committing it, and often the perpetrators don't even profit from it. In fact, many of the individuals involved in financial statement fraud consider their actions to be *beneficial* to the company that employs them.

According to the Association of Certified Fraud Examiners, financial statement fraud is a "scheme in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports."[1] While instances of financial statement fraud are much lower than other types of fraud, such as embezzlement or corruption, the losses are much higher.[2]

In this article, I present five examples of financial statement fraud: overvalued complex financial instruments, overstated intangible assets, understated liabilities, inflated revenue and institutionalized misreporting. For those frauds not fully within the public domain, I have used fictitious names to preserve the privacy of those involved.

Overvalued Complex Financial Instruments

HF, a hedge fund, provided liquidity to companies in the form of convertible debentures. These loans included an option to convert the debentures into shares of the company's stock based on a contractually stated conversion value per share. The conversion feature potentially adds value beyond that of the debentures if expectations are that the market price for shares will exceed the conversion price during the option period.

HF earned its fees based on the dollar value of assets under management (AUM): the higher the AUM, the higher the fees, creating an incentive for HF to report its assets at the highest possible values.

The loan markets tightened severely in 2007. Interest rates on collateralized debt obligations, repackaged bonds and loans, including subprime mortgage debt, rose sharply in December 2006 and January 2007. On July 10, Standard & Poor's slashed ratings on approximately $12 billion of subprime debt, and on August 9, the European Central Bank and the U.S. Federal Reserve injected $90 billion into the financial markets.

All the companies that owed money to HF were in a desperate condition throughout 2007. HF was a subprime lender when loan financing was drying up, the global economy was shrinking and the stocks of HF's borrowers were trading for cents and even fractions of a cent. The conversion options became worthless, while the values of the debentures declined sharply. Nevertheless, during its year-end reporting, these market indicators were not taken into account in HF's marks, most of which were reported at a gain, or in the worst cases, at cost.

Ultimately, the Securities and Exchange Commission brought an enforcement action against HF's founder, who received a significant financial penalty for his actions.

Overstated Intangible Assets

Logitech International is a Swiss company with substantial operations in the U.S., operating in the personal peripherals and video conferencing sectors. The mouse in your hand may bear the Logitech brand. In November 2009, Logitech acquired LifeSize Communications of Austin, TX, a company in the high-definition video communications industry.

In April 2016, the SEC issued a cease-and-desist proceeding against Logitech after discovering "recur-

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1 Association of Certified Fraud Examiners. *Report to the Nations on Occupational Fraud and Abuse: 2016 Global Fraud Study*, Glossary of Terminology, pg. 90.
2 Ibid., pg. 12.

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ring instances of improper accounting in three separate areas…during a five-year period."[3] These actions resulted in inflated earnings and improper accounting for some of its products, and two former executives were charged with securities fraud. Among the accounting irregularities was the company's failure to amortize intangible assets recorded at the time of the LifeSize acquisition. In early 2013, despite being informed of material errors in the calculation of amortization of its investment in LifeSize, senior accounting officials ignored the errors, continuing to overstate the company's investment by $1.87 million.

Understated Liabilities

Tom and Gerry met in the early 2000s. Gerry was wealthy, having made his fortune in an IPO during the 1990s. Tom was younger and developed commercial real estate. Gerry liked Tom and agreed to enter into a partnership to develop commercial real estate in Florida and Nevada. Gerry preferred to stay out of the daily operations of the partnership, letting Tom serve as the operating partner. Tom picked the properties and ultimately, Gerry's pockets.

While Gerry provided some equity support, his most significant backing came in the form of substantial lines of credit based on the strength of his personal financial position. Tom arranged for all of the credit line information to be sent to his Florida office, enabling him to draw on the credit lines without informing Gerry, who lived in California.

Instead of hiring a certified accountant, Tom relied upon the help of a friend who was "handy" with computers and who, under Tom's direction, managed dozens of accounts for each of the properties. At no time were these records audited by an independent CPA.

After drawing down all of Gerry's credit lines, Tom sought additional credit. He prepared his personal financial statements, listing his interest in the assets — but not the liabilities — of his partnership with Gerry. Tom obtained a significant loan from a local bank based on the perceived strength of these deceptive financial statements.

The properties' cash flow disappeared after the financial and real estate markets crashed in 2008, and Tom defaulted on the local bank's loan. In part because this loan was material to the bank's lending portfolio, the bank itself was forced to close, and federal regulators pursued a bank fraud case against Tom for misrepresenting his financial position.

Inflated Revenue

Between November 2011 and August 2012, Vincent Mehdizadeh purchased a controlling interest in Medbox, a company that sold vending machines capable of dispensing legal marijuana products on the basis of patients' biometric information.

During this period, Mehdizadeh also set up a shell company called New-Age Investment Consulting, promptly installing his fiancée as CEO, corporate secretary and chief financial officer.

3 SEC Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, in the Matter of Logitech International, S.A., April 19, 2016, pg. 2.

In late 2012, Mehdizadeh transferred his Medbox shares directly to New-Age, without registering this purchase. He created false paperwork documenting that New-Age had paid $552,000 for the shares, when New-Age had paid nothing.

Over the next few months, New-Age illegally sold Medbox shares as restricted securities in several private transactions, receiving millions of dollars in proceeds. To transfer these proceeds from New-Age to Medbox, Mehdizadeh fabricated revenue transactions, making Medbox's financial performance appear much stronger than it was. The SEC claimed that 90% of reported Medbox revenues in Q1/13 were false.[4]

Human ingenuity at committing fraud knows no bounds. Frauds are doubtless occurring today that will shock us when they are ultimately revealed. Nevertheless, it is helpful to understand how fraud has been perpetrated in the past and what ruses have been applied to gain an understanding of the vulnerabilities inherent in the financial reporting process.

When Medbox's accounting department requested backup to support the transactions, Mehdizadeh provided false and misleading statements to both the accountants and the auditors of the company. Eventually Mehdizadeh agreed to pay a $12 million fine in response to a complaint from the SEC.

Institutionalized Misreporting

Following the financial crisis of 2008, Toshiba, one of Japan's oldest and most respected companies, exhorted the leaders of its many business units to meet aggressive targets for revenue and profitability. When circumstances rendered those goals improbable, managers of those business units altered the books to provide the illusion they had met their performance goals.

Once details of the extensive fraud began to surface, the company engaged an independent team to investigate the fraud. The findings were released in a report in July 2015.[5]

The accounting fraud took many different forms and occurred over a lengthy period of time under the leadership of several CEOs. One of the primary ways the fraud occurred was through the company's accounting treatment under the percentage-of-completion method for contract work. This principle is used in contracts for services related to civil engineering, architecture, shipbuilding and manufacturing of machinery and requires any cost overruns to be recorded in the period in which they occurred.

Nevertheless, from 2008 to 2013, the investigators identified multiple projects for which expenses were not recorded until the project reached completion. In virtually every case, the managers told the investigative team they hoped cost overruns would be offset by cost reductions in subsequent periods.

When the targets were inevitably missed, the company was forced to make up for the previously unrecorded expenses in the final period, which resulted in understating expenses in earlier periods and overstating them in later periods. Over a period of almost seven years (2008 to Q3/14), the company had inflated its net profits by a cumulative $1.3 billion.

Forewarned is Forearmed

Human ingenuity at committing fraud knows no bounds. Frauds are doubtless occurring today that will shock us when they are ultimately revealed. Nevertheless, it is helpful to understand how fraud has been perpetrated in the past and what ruses have been applied to gain an understanding of the vulnerabilities inherent in the financial reporting process.

As consumers of financial statement information, there is nothing more essential than a healthy dose of skepticism. There can always be a 17th floor. abfj

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4 *SEC v. Notis Global, Inc. (f/k/a Medbox, Inc.), Vincent Mehdizadeh, et al.*, March 9, 2017, paragraph 6, pg. 3.
5 Investigation Report: Summary Version, 20 July 2015, Independent Investigation Committee for Toshiba Corporation (English translation version).

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