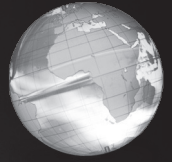


GLOBAL
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Detecting Accounting Fraud

Analysis and Ethics

Cecil W. Jackson

DETECTING ACCOUNTING FRAUD

customers and will turn into cash, the next period's sales will probably be paid only in the next period and will remain on the balance sheet in the current period as accounts receivable instead of turning into cash.

SIGNAL #2: CASH FLOW FROM OPERATIONS FALLING BEHIND OPERATING INCOME The second signal of inappropriately recorded sales is when cash flow from operations (CFFO) lags or falls behind operating income or net income. This is a prime signal; if a company is operating at a profit, why would it not be generating CFFO at a similar pace?

ARE THEY LIVING HAPPILY EVER AFTER?

- **Assaf, Pardue, and Simmons** consented to the SEC's final judgment "without admitting or denying the allegations." Assaf, Pardue, and Simmons were ordered to pay "civil money penalties of \$50,000, \$40,000, and \$50,000, respectively" (AAER 1020, 1998).
- **Sensormatic** was acquired by Tyco Inc. in November 2001 and was removed from the New York Stock Exchange because "fewer than 600,000 shares remain[ed] publicly held" (NYSE, 2001).
- **Ronald Assaf** resigned after Sensormatic was acquired by Tyco. Mr. and Mrs. Assaf are reportedly living in Boca Raton, Florida, where they are very active in the community. In January 2012, Mr. and Mrs. Assaf were awarded Nova Southeastern University's highest honor, the President's Community Award, for their "leadership and philanthropic gifts" ("NSU to Honor Ron and Kathy Assaf . . .," 2012).

XEROX: DO NOT DUPLICATE

Xerox is presented mainly as an example of Improper Timing of Revenue Recognition via the misuse of multiple-element contracts or bundled contracts.

The Xerox Corporation is a multibillion-dollar Connecticut-based company that specializes in the production, sale, and lease of duplicating machines and services. The company is known worldwide, and its name has become synonymous with "photocopying." In the period from 1997 to 2000, Xerox paid its auditors (KPMG) the sum of "\$55.8 million for auditing [its] financial statements" (AAER 2234, 2005).

AN OVERVIEW OF XEROX'S FICTITIOUS FINANCIAL REPORTING SCHEMES

The SEC found that Xerox accelerated recognition of its equipment revenue by more than \$3 billion over the period 1997 through 2000 and "increased pre-tax earnings by \$1.5 billion."³ The SEC findings also alleged that "KPMG's failure to comply with

³ "Pursuant to a consent to settlement by Xerox, the company also was assessed a civil penalty of \$10 million. In consenting to settlement, Xerox neither admitted nor denied the allegations of the Commission's Complaint." As set out in AAER 2234, April 19, 2005.

generally accepted auditing standards (GAAS) caused and willfully aided and abetted Xerox's violations."⁴ (Quotes from AAER 2234, 2005)

Xerox provides a dramatic illustration of fictitious reporting by improper timing of revenue recognition through the misuse of multiple-element contracts or bundled contracts.

Scheme #1: Improper Use of Multiple-Element Contracts or Bundled Contracts

The major offending accounting actions in the SEC complaint were concerned with Xerox's treatment of its lease contracts. Typically, Xerox customer leases generate revenue from three streams:

1. The equipment revenue known at Xerox as the "box" revenue. This revenue is earned by making the physical asset (the copy machine itself) available to the customer, and it is legitimately recognized at the beginning of the lease in sales-type leases.
2. Revenue for servicing the equipment. GAAP requires this revenue to be recognized over the life of the lease.
3. The financing of revenue on the effective loans to the lessees. GAAP also requires this revenue to be recognized over the life of the lease.

The SEC found that Xerox shifted revenue in the following ways:

- Xerox shifted revenue from its servicing revenue stream to the box revenue stream, making it appear as revenue received for physically transferring the equipment to the customer. This was done in order to recognize future service revenue at the beginning of the lease. Xerox's internal name for the accounting method whereby it shifted this revenue was its "return on equity" method.
- Xerox also shifted certain portions of its financing revenue to the box or equipment revenue stream so as to recognize that revenue at the beginning of the lease. Xerox's name for the accounting method under which it made this shift was the "margin normalization" system.

According to the SEC, "These two methodologies, which did not comply with GAAP, increased Xerox's equipment revenues by \$2.8 billion and its pre-tax earnings by \$660 million from 1997 to 2000." The SEC complaint alleged that Xerox failed to disclose its use of these methods, "which were changes in accounting methods and changes in accounting estimates." (Quotes from AAER 1542, 2002)

Scheme #2: Estimates of Discount Rates and Residual Values

Further, an article in *The Accountant* described an SEC complaint against the Xerox auditors, KPMG, as follows: "Between 1995 and 2000, Xerox always assumed a 15 percent return . . . despite significant volatility in the returns actually earned by leasing companies" ("SEC Complaint . . .," 2003). Leasing companies discount future cash flows when they recognize the amounts in current income. (**Discounted future cash flows** refer to the present value of the future cash that a company expects to receive or pay.) By choosing a particular discount rate, a leasing company can manipulate its reported

⁴ KPMG consented to the entry of this order without admitting or denying the finding therein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings. As set out in AAER 2234, April 19, 2005.

income. The SEC also alleged that Xerox increased its reported earnings by changing estimates of the residual values of its leased assets. (Note: KPMG strongly defended its audit work at Xerox.)

Scheme #3: Improper Disclosure of Sales of Leases

Xerox also sold approximately \$400 million of its existing leases. This occurred after Xerox Brazil changed its emphasis from sales-type leases to operating leases. This revenue from the operating leases would have been received over a number of years over the durations of the leases. However, the sale of the receivables to a lender caused the revenue to be recognized immediately and the cash to be received immediately. The nondisclosure of these sales had the dual effects of making the operating income in the period of the sale look better than it was, as well as making the cash-flow situation look stronger: “This added \$182 million in pre-tax profits to Xerox’s 1999 results” (AAER 1542, 2002).

OTHER MISSTATEMENTS The SEC also alleged that Xerox boosted its earnings by creating cookie-jar reserves⁵ and then reversing those unneeded reserves back into profits in later periods. In addition, the company improperly disclosed the gain on a one-time event with the result of boosting the appearance of extra profits from ordinary, recurring operations.

SIGNALS OF XEROX’S FICTITIOUS REPORTING SCHEMES

The first two signals listed next apply to all methods of overstating revenue. The next two signals apply to Xerox’s specific methods of overstating revenue.

SIGNAL #1: INCREASE IN ACCOUNTS RECEIVABLE AS A PERCENTAGE OF SALES Examine the accounts receivable-to-sales ratio as measured, for example, by DSO or by days’ revenues outstanding (DRO). When a company shifts revenue from a stream that should be recognized in a later period in order to have it recognized in a current period, its revenues, operating income, and net income increase, but its cash received does not. Instead, the company’s accounts receivable increase.

SIGNAL #2: CFFO FALLING BEHIND OPERATING INCOME OR NET INCOME When CFFO decreases relative to operating income or net income, this is the prime signal of a company recognizing any form of profit ahead of time. CFFO refers to the amount of cash generated after expenses from the company’s main operating activities, such as sales, services rendered, or other operating activities. At Xerox, CFFO went from 26% of net income for 1996, to 33% for 1997. Then for 1998, the company actually generated a *negative* CFFO of \$1,165 million compared to positive reported net income of \$395 million. This dramatic lagging of CFFO behind net income should have been a major red flag, signaling that something was seriously amiss regarding Xerox’s reported

⁵ Recall that “cookie-jar” reserves refer to reserves created by overstating a future liability in one period to release it in a future period, thereby fictitiously implying that the company has less expense in the future period.

profit. Suddenly, in 1999, CFFO turned around dramatically, to positive \$1,224 million, compared to net income of \$1,424 million—a ratio of 86 percent.

It was later revealed that in 1999 Xerox had sold approximately \$400 million of its accounts receivable. When a company sells its accounts receivable, this increases its reported CFFO. To test whether CFFO is lagging behind operating income or net income, one must deduct the amount of sold accounts receivable from CFFO before comparing CFFO to operating income or net income. After making this adjustment, anyone looking at the signal of CFFO lagging reported net income should have been suspicious that Xerox was dramatically accelerating its reported income. (For this signal and Signal #1, securitized or sold receivables should be added back to accounts receivable and deducted from CFFO.)

SIGNAL #3: CHANGES IN PROPORTIONS OF REVENUE STREAMS If the revenue streams are reported separately and the stream in which revenue is immediately recognized increases in proportion to the stream(s) where revenue recognition is delayed (over the life of the contract), it is a signal that the company could be shifting revenue to accelerate its recognition. If this is accompanied by Signal #1 (an increase in the accounts receivable-to-sales ratio), the alert becomes stronger.

SIGNAL #4: SALES OF ACCOUNTS RECEIVABLE Any disclosure in the financial statements (or in the press) that a company has “factored” or sold its accounts receivable—or any future revenue stream—should alert the reader to test for all signals of accelerating revenue recognition. Xerox sold accounts receivable without disclosing it immediately. In such a case, as soon as information is released that a company has factored its accounts receivable, one should realize that this, in itself, could be a signal that the company has accelerated its sales. In addition, one should be aware that this factoring of accounts receivable would have concealed Signal #1 because the factoring would have reduced the buildup in accounts receivable.

ARE THEY LIVING HAPPILY EVER AFTER?

- **Six former Xerox company officials** agreed to pay over \$22 million in penalties, without admitting or denying the SEC’s allegations (SEC Press Release, 2003).
- A criminal investigation into **Xerox’s** accounting practices was concluded in October 2004, and U.S. prosecutors did not file charges (“Xerox Cleared . . .,” 2004).
- **KPMG** “agreed to settle the SEC’s charges against it in connection with the audits of Xerox Corp. from 1997 through 2000” (LR 19191, 2005). As a result of this civil litigation, KPMG agreed to pay a total of \$22.475 million in penalties. KPMG was also ordered to develop reform plans to ensure that SEC violations do not recur (LR 19191, 2005).
- “KPMG consented to the entry of the Order without admitting or denying the SEC’s findings” (LR 19191, 2005).
- In March 2008, **Xerox** agreed to pay \$670 million and **KPMG LLP** agreed to pay \$80 million to settle a “lawsuit filed on behalf of Xerox investors who claimed Xerox committed accounting fraud to meet Wall Street earnings expectations” (Taub, 2008). The case was settled without any admissions of wrongdoing.

CUC: PHONY FUNDS⁶

CUC is presented mainly as an example of Improper Revenue Recognition via reporting fictitious revenue.

CUC International, Inc., was a company (registered in Delaware) that sold club memberships to its customers for automobile, dining, shopping, and travel services. Another Delaware company, HFS Incorporated, controlled franchise brand names in the hotel, real estate brokerage, and car rental industries. These two companies merged in December 1997, taking the name of Cendant Corporation, which carried on the combined activities of the two formerly separate companies.

The SEC maintained that the fraud began with the original CUC as far back as 1985 and was allegedly directed by CUC's chairman and CEO, Walter Forbes, from the very beginning. The SEC's complaint also alleged that CUC's president and COO, E. Kirk Shelton, joined Forbes in directing the scheme from at least 1991 onward (AAER 1372, 2001; LR 16919, 2001). The Commission also contended that Cosmo Corigliano, who served as controller of CUC from 1983 to 1995 and as CFO from 1995 to 1997, "assisted senior CUC officers who initiated the long-running financial reporting fraud and later, as CUC's Chief Financial Officer, proceeded to orchestrate and refine the fraud" (AAER 2014, 2004; LR 18711, 2004).⁷ Referring to the CUC case, Richard Walker, SEC Director of Enforcement, noted that "large, complex, and long-running financial frauds often originate at the highest levels of a company" (AAER 1372, 2001; LR 16919, 2001).

According to SEC records, another pivotal individual involved in the execution of the schemes was Mary Sattler Polverari, a CPA who was hired by CUC in December 1995 and became manager of financial reporting in 1997. The SEC maintained that Polverari carried out instructions that "included adjustments increasing revenue . . . and decreasing particular expense line items" (AAER 1275, 2000).⁸

AN OVERVIEW OF CUC'S FICTITIOUS FINANCIAL REPORTING SCHEMES

According to the Securities and Exchange Commission, beginning in at least 1985, "certain members of CUC's senior management implemented a scheme designed to ensure that CUC always met the financial results anticipated by Wall Street analysts. The CUC managers utilized a variety of means to achieve their goals" (AAER 1275, 2000).

The SOX Report (2002) found 80 enforcement matters in which companies reported fictitious revenue, and the report described several ways in which improper revenue recognition involving fictitious revenue occurred: "The manipulation of revenue was accomplished through, among other means, the falsification of sales documents, side agreements with customers that were not recorded, and top-side adjustments by senior management" (p. 11).

⁶ The fraud occurred at CUC before the company merged with Cendant.

⁷ Cosmo Corigliano and others "consented to the entry of the Final Judgment without admitting or denying the allegations of the complaint." As set out in LR 18711, 2004.

⁸ Mary Sattler Polverari consented to the entry of the order without admitting or denying the findings. As set out in AAER 1275, 2000.

One of CUC's primary methods of fictitious revenue reporting was through the use of top-side adjustments. In addition to the **top-side entries**, entries recorded in the financial statements but not in the general ledger or other formal accounting records, CUC also transferred some amounts for deferred club membership revenues to current periods' revenues. Further, the company created huge overstated merger reserves, which it used as cookie-jar reserves to be released into profits in later periods. After the merger of CUC with HFS, Inc., the newly established Cendant discovered the CUC fraud. In 1998, this represented the biggest accounting fraud ever revealed in the United States. However, in the first decade of the 21st century, the CUC fraud was surpassed by several much larger accounting frauds. CUC is presented in this chapter as an example of overstating revenue by the use of *fictitious revenue*. (Note that WorldCom is examined in this text as an illustration of the fraudulent use of merger acquisition reserves.)

The CUC Scheme of Reporting Fictitious Revenue via Top-Side Adjustments

For the hands-on part of the scheme that required actually making the top-side adjustment (adjustments made in the financial statements and not in the general ledger), the alleged role of Polverari was important. She received the financial reports from all the business units and compiled a monthly report showing the results of each unit. Each quarter she submitted the quarterly consolidated report to her supervisors. This was when the scheme started. Polverari's supervisors would devise instructions describing adjustments for her to make: "Typically the instructions included adjustments increasing revenue by a certain amount and decreasing particular expense line items by certain amounts" (AAER 1275, 2000). Most of the alterations were concentrated on the Comp-U-Card division. The adjustments always increased earnings, and they never had supporting documentation. The SEC commented:

The adjustments were entirely top-side adjustments. That is, the adjustments were simply entered into Polverari's spreadsheet at Stamford—no journal entries were created, no entries were made to CUC's general ledger, and the adjustments were not carried down to the books and records of Comp-U-Card or any of the company's other divisions. (AAER 1275, 2000)

Clearly, the revenue recognized in this manner was entirely fictitious, with no accounting explanation provided for the entries. However, the explanation given to Polverari for the entries was amazingly frank. She was apparently informed that "CUC's chief financial officer had generated the adjustments to inflate CUC's quarterly results so that the results would meet earnings expectations of Wall Street analysts." Polverari was even told that some of the adjustments were made to achieve percentage targets for some expenses and that some of the adjustments were "to ensure that items such as receivables and cash were at levels he [the CFO] thought desirable." (Quotes from AAER 1275, 2000)

The Commission found that for the fiscal years ended January 31, 1996; January 31, 1997; and December 31, 1997, the top-side alterations aggregated \$31 million, \$87 million, and \$176 million, respectively. Because the top-side entries were not entered in the company's general ledger, something had to be done to align retained earnings with the