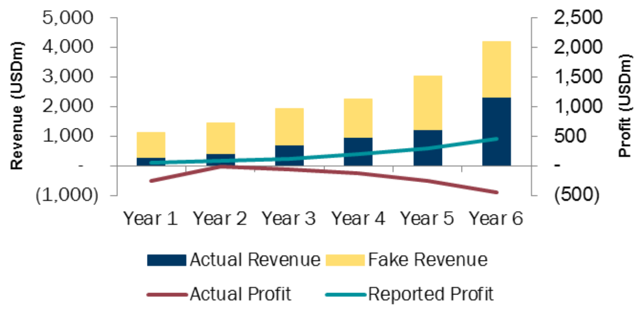
# Fraud 101 — Back To School

It's that time of year again — new uniform pressed, pencils sharpened, shoes shined, fake invoices being printed. As a new school year starts, we thought it would be an opportune time for a refresher class on how to commit fraud — large scale, illegal, personally enriching financial statement fraud. Welcome back to school everyone. Class is in.

This article was written in light of the regularity of the types of frauds we have been seeing lately, making it seem like fraudsters are following a how to guide on committing fraud. There is plenty more to cover and a number of tricks to go over — unless of course you are a fraudster about to appear in Court. Let's start.

**Composition of Revenue & Actual vs. Reported Profit**




**LESSON 1: Fraud schemes always get bigger over time – as do the losses incurred by stakeholders when it collapses.**

## What is Financial Statement Fraud?

Financial statement fraud is the deliberate misrepresentation, misstatement or omission of financial information from the financial statements for the purpose of misleading the reader and creating a false impression of an organisation's strength.

Whilst the size of financial statement fraud can be large (actually extremely large — think Enron, WorldCom and Parmalat), the ways in which it occurs are rather limited. On an accounting level it can basically be broken down to the overstatement of revenue and the understatement of expenses or the overstatement of assets and the understatement of liabilities. However, what fraud allows, is for debt to be sourced, unsuspecting investors introduced, covenants met and inventory supplied. All of these consequences can have a dire impact on the innocent counterparties involved.

From our experience such fraud is not always committed for personal gain; fraud is often initially committed to mask the true position of a struggling business only to have the fraud spiral out of control. The fraud spiral is often fuelled by what we call the 'costs of fraud' — i.e. taxes to be paid on fraudulent gains, dividends to be paid to unsuspecting investors, interest to be paid on debt sourced to either cover the real losses incurred by the business or for acquisitions to help camouflage the actual fraud. More on the costs of fraud later.

## Recap — Conducting Financial Statement Fraud

Of the ways to conduct financial statement fraud, certainly the most common is the overstatement of revenue. There are numerous ways this may be implemented — think fake deliveries to related parties, channel stuffing, partial shipments, revenue from consignment stock, liberal returns policies, post-year end transactions — all of which can be fairly simple to implement yet enormous in magnitude.

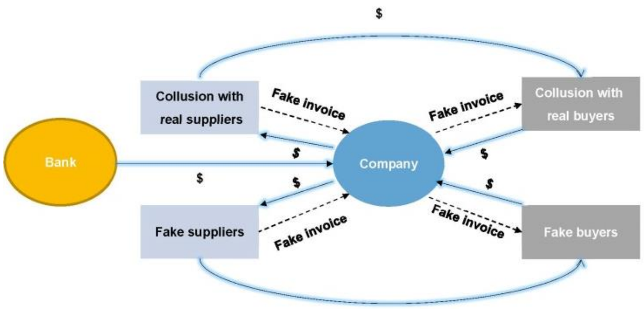
If financial statement fraud is to remain masked, a fraudster will usually need to implement a fake trading scheme which is fairly easy to establish by following a few simple steps:

- Incorporate 'unrelated' and 'independent' counterparties, in jurisdictions outside the company's main jurisdiction;
- Appoint 'unrelated' friends, family or colleagues as directors and shareholders; and
- Generate invoices reflecting fake transactions with the 'new' counterparties — both for sales and purchases.

In the words of a senior magistrate in Milan conducting the Parmalat investigation (the Italian dairy giant once described as 'the Coca Cola of milk' which collapsed owing EUR14 billion in debt), 'what surprises me is the simplicity.'

A fraudulent trading scheme uses a series of controlled companies as suppliers and customers, enabling a 'legitimate' route for cash to be funneled out of the company, usually at the expense of financiers through the provision of trade finance and term loans. On one matter we were engaged to, two of the company's accounts staff were employed full-time just to generate fake invoices to submit for trade finance funding.

**The Fraudulent Trading Scheme**




**LESSON 2: Whilst fake purchases lower profit, they are an essential part of the fraudulent trading scheme as payment of fake supplier invoices enables money to be funneled out of the company.**

Of course overstating revenues from a fake trading scheme is not the only form of financial statement fraud. Understating expenses is just as effective when it comes to inflating profits. Capitalising expenses (i.e. converting expenses — cost of goods sold — to supposed related party loan receivables) is one way to achieve this. Alternatively, the use of 'buying agents' — being related parties acting on the company's behalf — to purchase stock and 'on-sell' the products can be used to the same effect.

The added benefit of this approach is it serves to understate a company's liabilities by not disclosing all of them — in the form of Accounts Payable — thus improving the apparent health of the company. WorldCom mastered this technique, understating expenses by some USD3.8 billion.

Purchasing fixed assets at an inflated price from an intermediary or connected party is one way to overstate the size of a business. Similar to fake purchases in a false trading scheme, it is also a way to funnel cash out of a business to an 'unrelated' party at a mark–up on the real cost of the assets. When investigating the accounts of Moulin Global Eyecare, which had claimed to be the world's third largest spectacle maker, the liquidators found in excess of USD500 million of assets simply didn't exist, whilst Daewoo — which had 320,000 employees and USD80 billion of debt when it collapsed — was trading assets between sister companies and the capital gains booked as profit. In Japan, Olympus made payments for assets and fees of at least USD1.6 billion to cover up bad investments made over decades.

Of course a fraud can only be perpetrated for so long before stakeholders might become suspicious. One solution we have encountered on numerous occasions to counter this is covering up by acquisition — i.e. the purchase of a healthy, performing company to mask the underperforming original business and the associated fraud. Given the usual ready supply of fresh equity and debt the fraudulent business is able to attract with its fraudulent performance, acquisition becomes a logical step, often at inflated prices. Peace Mark had so substantially overpaid for its many acquisitions that goodwill comprised 50% of its acquisition costs and 20% of its total assets.

**LESSON 3: Buying a real business is often used to hide the existence of a fake business.**

Paramount to a fraud enduring is surviving the annual audit. A few easy steps however makes this fairly routine. Postal addresses for companies involved in the fraudulent trading scheme need to be controlled by the fraudsters to facilitate completion of the obligatory confirmation letters for creditor and debtor balances. The more remote the locations that are used to 'hold' inventory, the less likely stock takes will occur, however we have also encountered occasions of fraudulent companies having fake inventory on consignment, rotating inventory between sites and even borrowing inventory to survive such inconveniences.

Timing repayments from fake debtors to satisfy subsequent receipts testing is also a wise move for the fraudster on top of their game. For the lazier fraudster, journal entries from more highly scrutinised balances — such as Accounts Payable and Receivable — to catch-all accounts such as Other Assets and Other Liabilities is a helpful approach during the year as auditors don't really look at inter-year movements. Similarly, as some of the largest frauds conducted have evidenced, if moving cash between accounts is not sufficient to pump up year end balances, forging bank statements can be just as effective given so many audits are not executed as planned. Again, when Parmalat collapsed it admitted that EUR3.95 billion of cash simply did not exist. There have also been occasions in China where auditors have attended banks to verify balances and been met by personnel purporting to be bank staff, but were not.

**LESSON 4: Don't trust audited accounts. Ever.**

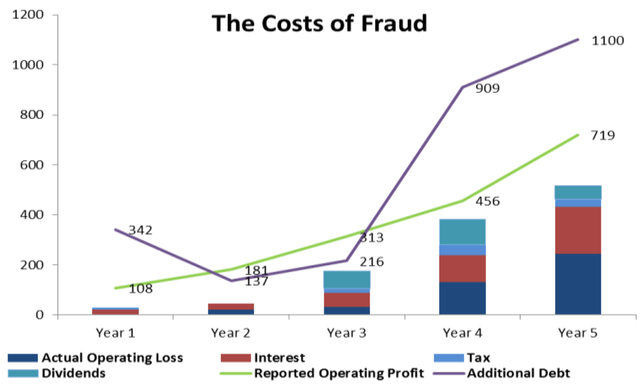
## The Cash Trap

The problem with fraud (other than being immoral and illegal that is) is that it is an expensive thing to do. We touched on the concept of the costs of fraud earlier but let's explain it a little further. A common motive to engaging in financial statement fraud is to make the business appear more profitable than it actually is. This helps improve share prices, meet covenants and earn bonuses. Many businesses engaging in financial statement fraud are actually incurring losses. And so for a company incurring losses but reporting profits, they need to fund those losses and that's where debt funded fraud comes into it.

But it doesn't stop there. There are unavoidable consequences of reporting profits whilst actually incurring losses. The first is the taxman. If you report profits, he wants his share of them and for companies that are actually incurring losses, they need to fund those tax payments. Shareholders also expect dividends when the company is regularly reporting profits, which is another cost that the real loss making company will need to fund.

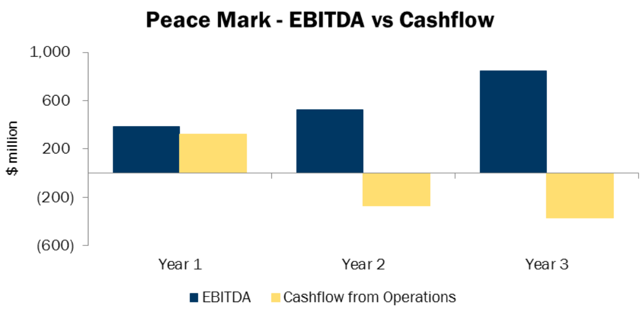
And with all that debt being incurred, including to conduct the fraudulent trading scheme, the company's interest cost will be going through the roof. Yet another 'cost of fraud' to fund. Funded by more fraud, and financed by more debt that ultimately just makes the problem worse.

And this is a fundamental part of why the losses to financiers are so large when these companies collapse. Huge amounts of debt have been used just to fund interest, dividends, taxes and real operating losses rather than any theft by the fraudsters themselves (although they may profit through their share of dividends paid).




**LESSON 5: The 'costs of fraud' need to be funded by even more debt and lead to even greater losses for creditors, most of which cannot be recovered after the company collapses.**

And this brings us to the other issue involving cashflow and companies engaging in financial statement fraud. Whilst it is relatively easy to overstate profit, it is much harder to overstate operating cashflow.




There is a high incidence of companies that conduct fraud reporting positive and improving profitability (whilst actually incurring losses), but also reporting negative operating cashflow.

This is because whilst cash used to fund the fraudulent trading scheme can help improve operating cashflow, over time, the real cash needed to fund the costs of fraud will restrict the extent of cash available to fund the fraudulent trading scheme. And so, the fraudster must undertake more fraud to get more financing to meet the costs of fraud. The problem snowballs. Hence why the company collapses, or conducts a large acquisition to try and gain access to more cash and then collapses, or starts to sell off assets to gain access to more cash and then collapses.

**LESSON 6: Faking profit is relatively easy; faking operating cashflow is much harder.**

# Learning from the Mistakes of Others

It is always important to learn from others and we have put the following together as a guide of what other fraudsters have done.

**Case Study 1**: The company, an electronics producer, proudly promoted its key customers being global high-end producers and retailers. A review of the debtors ledger however would simply have revealed a bunch of no name companies that sounded like they were bought off a register of shelf companies — which is because they were. What's more, they were even Hong Kong incorporated companies and a quick company search of them in Hong Kong would have revealed commonality of directors and shareholders. *TIP: If you are going to set up a series of fake customers, use a different jurisdiction and use different directors and shareholders for each company.*

**Case Study 2**: The company, a specialty manufacturer, had breached covenants. A review of its financial statements indicated some strange patterns in relation to sales and accounts receivable. A request to see the debtors ledger was initially met with claims that the accounting system was down, followed by the accountant was off sick. When the ledger was forthcoming, it was full of incomplete names and lacking in detail. *TIP: If trying to convince others that your fake debtors are real, at least go to the trouble to make up full and proper names for them.*

**Case Study 3**: The company, an electronics component producer, had debtors with shipment addresses as post office boxes. Another manufacturer had its largest debtor located at a Chinese restaurant in a remote US town. And another company used addresses at a shared executive office and in an office above Lan Kwai Fong, Hong Kong's bar district. *TIP: If you are coming up with addresses for fake debtors/ customers, make them at least a little bit believable.*

**Case Study 4**: Given the extent of fake sales and resulting fake receivables that had been created, the company transferred by journal entry material parts of these balances during the period to 'other current asset' accounts. It then came up with a series of descriptions to explain these items, including that they were deposits to customers, prepayments to customers, other receivables with affiliates and advances for business development for hundreds of millions of dollars. *TIP: Sometimes it might just be more believable to leave your fake debtors as fake debtors.*

**Case Study 5**: The company had set up fake suppliers and customers. Payments were made to the fake suppliers but receipts that were recorded as coming from the customers, actually came back from the suppliers. *TIP: If conducting a fraudulent trading scheme, don't be lazy and take shortcuts.*

**Case Study 6**: The company was collapsing and trying to cover their tracks. *TIP: If deleting data, don't forget to delete the invoice templates for fake customers, go to the trouble of taking the records you are trying to destroy to another building's rubbish bin, delete the email server, not just emails off individual computers, completely throw away the hard drives and don't just leave your fake records in a secret office hoping no one will find that office.*

**Case Study 7:** Many Asian fraud-related collapses comprised part of their business as a distribution, wholesale or trading business. This is where the fraudulent trading scheme is typically housed. *TIP: No one pays any attention to the business' one sentence description in the annual report, just to the glossy photos.*

## In Conclusion

Losses arising from financial statement fraud can be extremely large. Whilst investors suffer first in terms of recovery from a deterioration in share price, it is the debt providers — trade finance, term loans and bondholders — which are often the targets of fresh funding. Regardless of whether you are an investor with only an annual report and the internet at hand or a stakeholder privy to additional information, there will be warning signs for fraud for those that look diligently, inquire intelligently and think carefully. As long as stakeholders remain professionally skeptical and investors inquisitive the warning signs of fraud will be there if you know where to look.

Or contact us, and we'll look for you. We've seen it all before.

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