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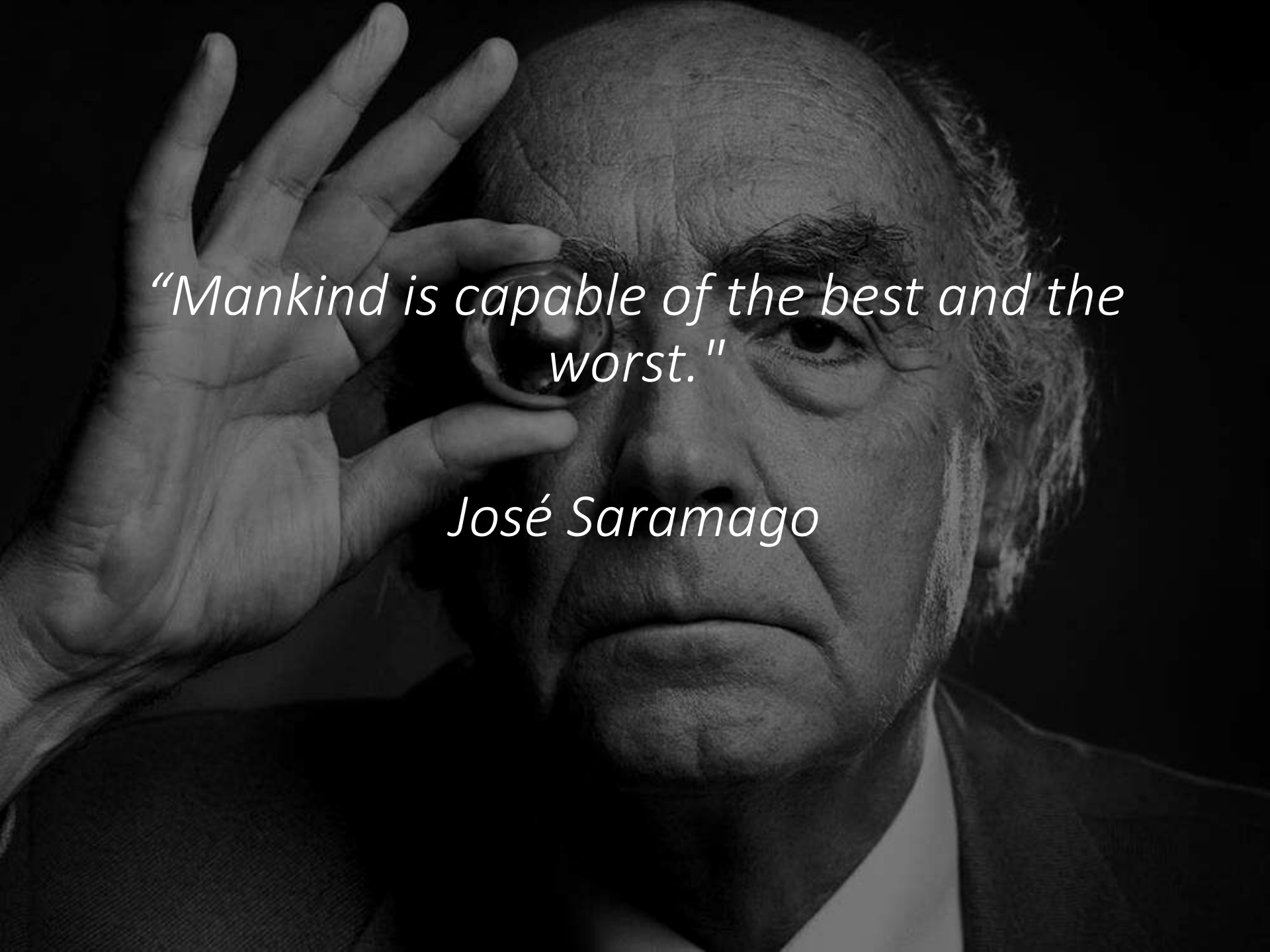
Webinar

From crisis to fraud: income smoothing and creative accounting


“Mankind is capable of the best and the worst."
José Saramago

Agenda

1. Financial crises, the great catastrophes
2. Innovation vs. regulation
3. Frauds and those who perpetrate them
4. Fraud warning signs

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From Crisis to Fraud

1866, 1890

OVEREND, GURNEY & Company; BARINGS

1930

The Great Depression

1980

Default on payments by several developing countries

1990

Japan and the Nordic countries

1997

The Asian crisis

2000

The “dot-com” crash

2007

Collapse of the Housing market in the United States

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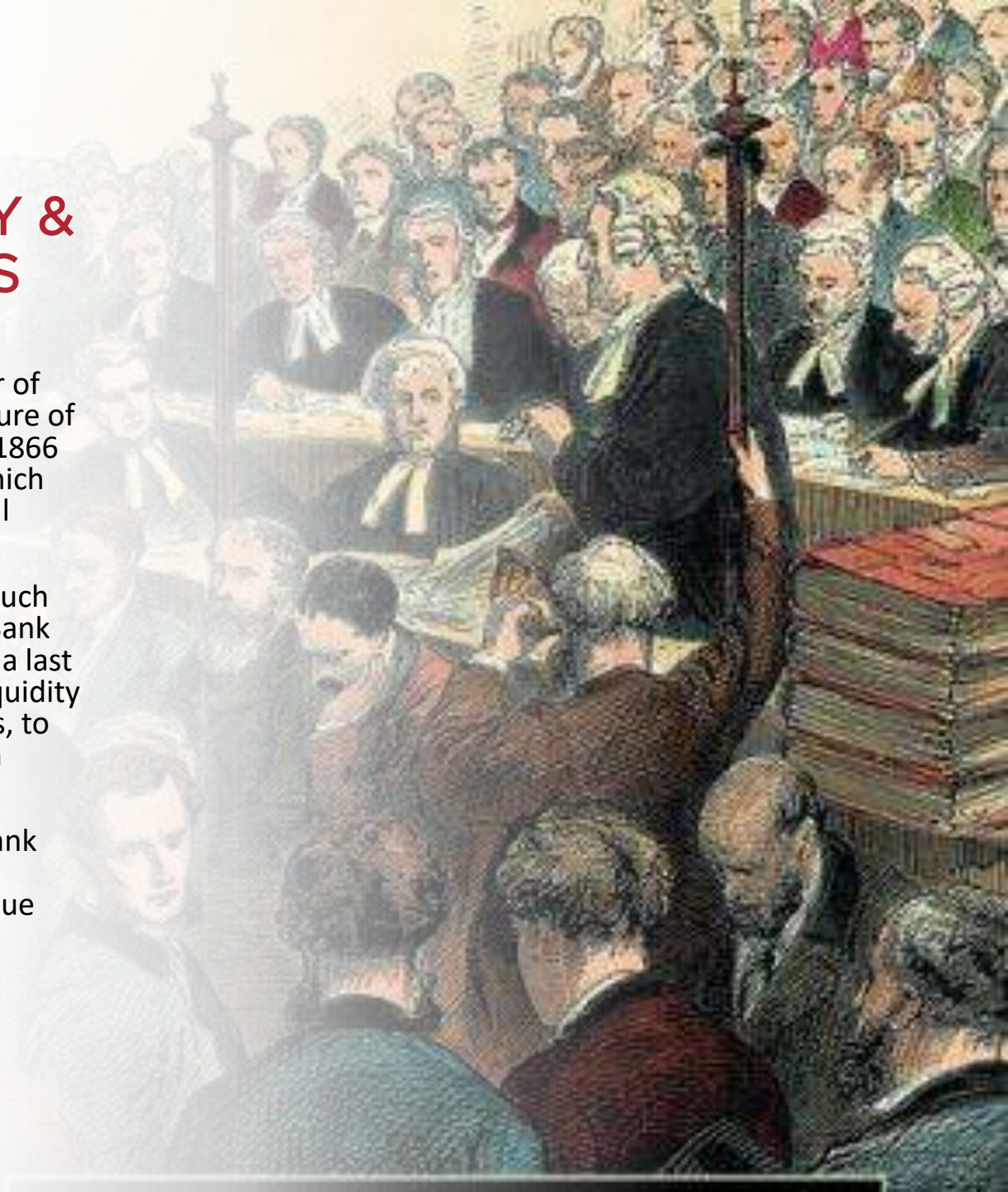
OVEREND, GURNEY & Company; BARINGS 1866,1890

- The Bank of England was the center of the global financial system. The failure of such an important London bank in 1866 led to a key reform in the way in which the central banks managed financial crises.
- As a result of this crisis, reformers such as William Bagehot pressured the Bank of England to take on a new role as a last resort lender that would provide liquidity to the financial system during crises, to prevent the collapse of a bank from spreading to others.
- Secret negotiations between the Bank and British financiers led to the establishment of a £ 18 million rescue fund in November 1890, before the extent of Barings' losses was made public.



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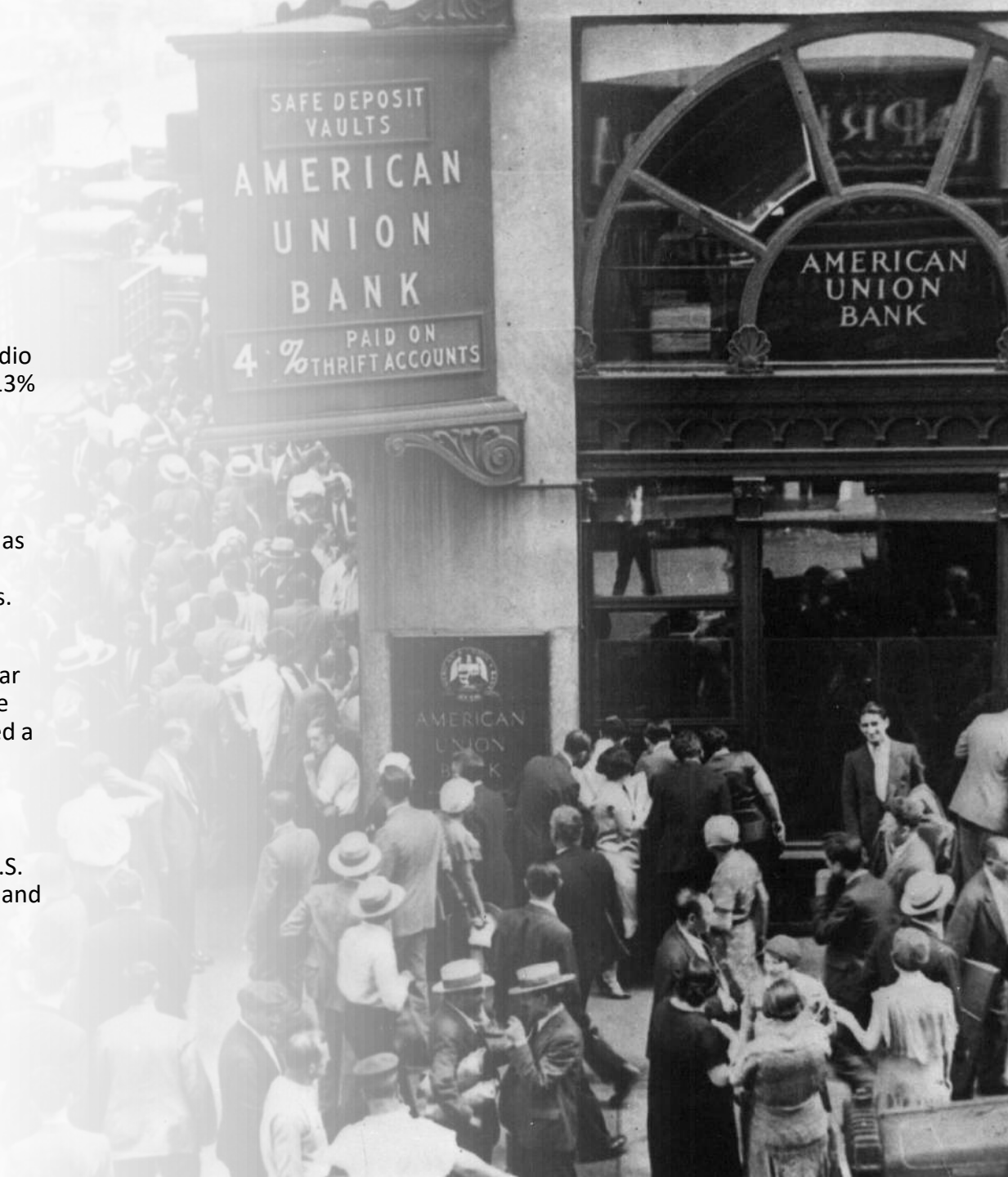
1929 – "Black Thursday"

- By the end of the 1920s, after enormous speculative growth, largely because of the emergence of new industries such as the radio and automobile manufacturing, stocks fell 13% on Thursday October 24, 1929.
- It took 25 years for the Dow Jones Index to regain its 1929 level
- Purchases of durable consumer goods such as cars and houses dropped, while industries postponed investments and closed factories.
- The U.S. Federal Reserve also increased the interest rate to protect the value of the dollar and to preserve the gold standard, while the government increased tariffs and maintained a fiscal surplus.
- The New Deal also introduced extensive regulation to financial markets and to the banking systems, with the creation of the U.S. Securities and Exchange Commission (SEC), and the Federal Deposit Insurance Corporation (FDIC).



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THE SAVINGS AND LOAN SCANDAL OF 1985

- In the decade of the 1980s, financial deregulation began to allow those smaller banks to participate in more complex transactions in order to compete with the larger commercial banks.
- By 1985, many of these institutions were close to bankruptcy and a banking panic occurred in the S&L of Ohio and Maryland.

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THE CRASH OF OCTOBER 1987

- Low interest rates, especially in the UK, could have contributed to the bubble that occurred in the housing market in 1988-89 and the pressures that drove sterling to a devaluation in 1992.
- The crash was caused by the widespread belief that the improper handling of confidential information and the acquisition of companies with money that originated from loans were controlling the market, while the United States economy was stalled.
- The crash also demonstrated that global stock markets were now interconnected, and that changes in the economic policy of one country could affect markets around the world.
- Laws regulating the inappropriate handling of confidential information were also reinforced in the United States and the United Kingdom.

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LONG-TERM CAPITAL MARKET 1998

- The collapse of the Long-Term Capital Market (LTCM) financial fund occurred during the final stage of the global financial crisis that started in Asia in 1997 and spread to Russia and Brazil in 1998.
- Russia stopped paying on its treasury bills in August 1998. Investors retreated from credit instruments from other countries and sought refuge in U.S. Treasury Bonds.
- Immediately the different interest rates among the bonds began to increase dramatically.

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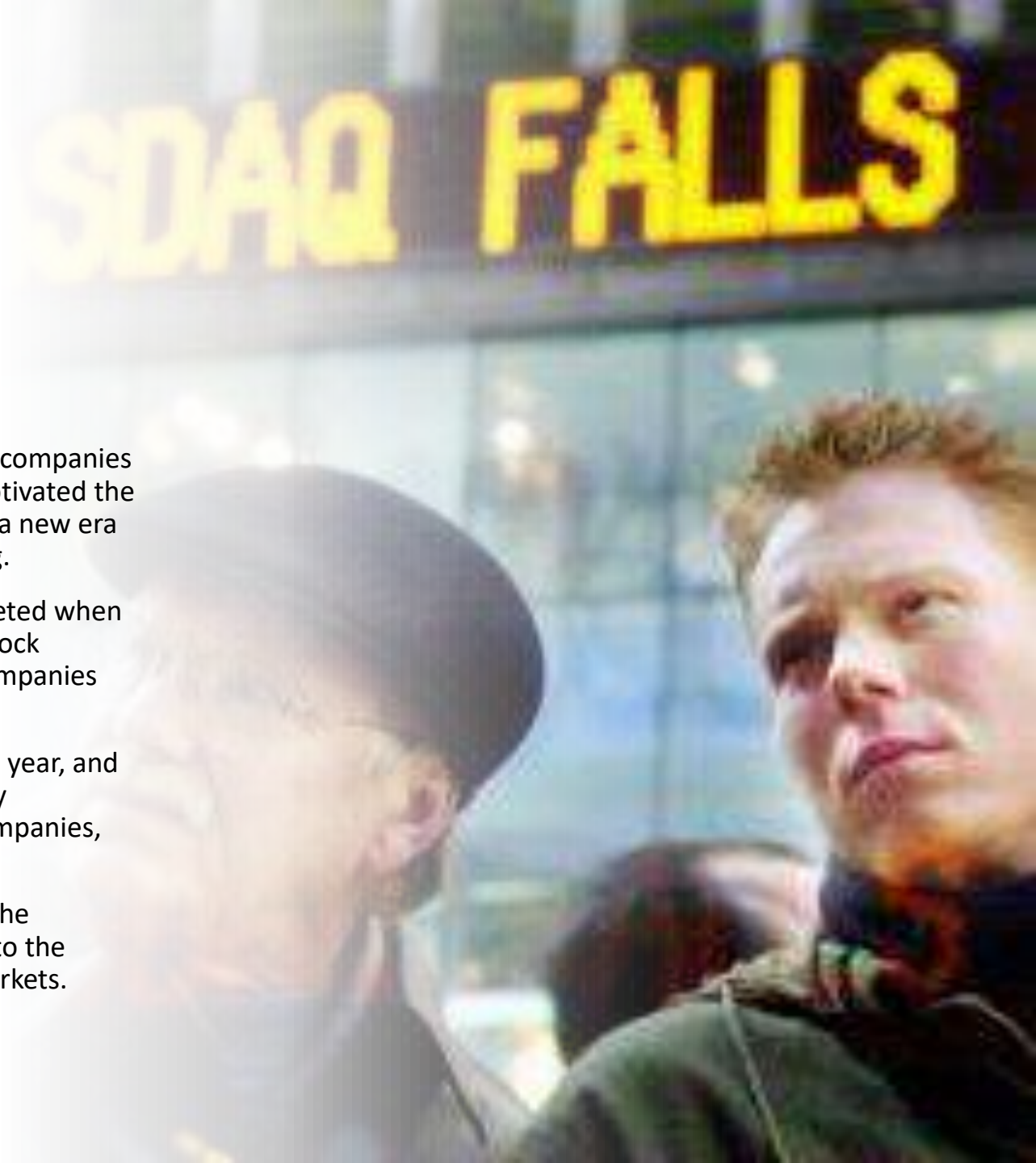
THE DOT-COM CRASH OF 2000

- By the end of the 1990s, Internet companies such as Amazon.com and AOL captivated the stock market, and it seemed that a new era for the economy was approaching.
- The price of these shares skyrocketed when they were listed on the Nasdaq stock exchange, although few of the companies were actually making a profit.
- The bubble burst in March of that year, and the Nasdaq index, which is heavily concentrated with technology companies, fell 78% in October 2002.
- The process was exacerbated by the September 11 attacks, which led to the temporary closure of financial markets.



What can be learned from the major financial crises of the past?

- Globalization has increased the frequency and spreading of financial crises, but not necessarily their severity.
- Early intervention from central banks is more effective at containing them than actions that are taken too late.
- At the time of a financial crisis it is difficult to know if it will have more serious consequences.
- Quite often regulators fail to keep up with the pace of financial innovations that could trigger a new crisis.

Fraud

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Main types of Fraud According to the ACFE*

- Asset Theft
- Corruption
- Accounting Fraud

*ACFE (Association of Certified Fraud Examiners)

Accounting fraud

Consists in intervening in the process of preparing the financial information **with the purpose of getting the accounts to reflect an image different from what they would show, had manipulation not been practised.**

Frauds are committed to make accounts reflect what is of interest to management and administrators.

Types of accounting fraud

- **Legal:** profiting from foreseen alternatives in legislation. **"Creative accounting."**
- **Illegal:** practices not permitted by prevailing legislation (hiding sales or expenses, recording fictitious sales or expenses, hiding assets or debts, etc.)
- Real legal transactions
- Real illegal transactions

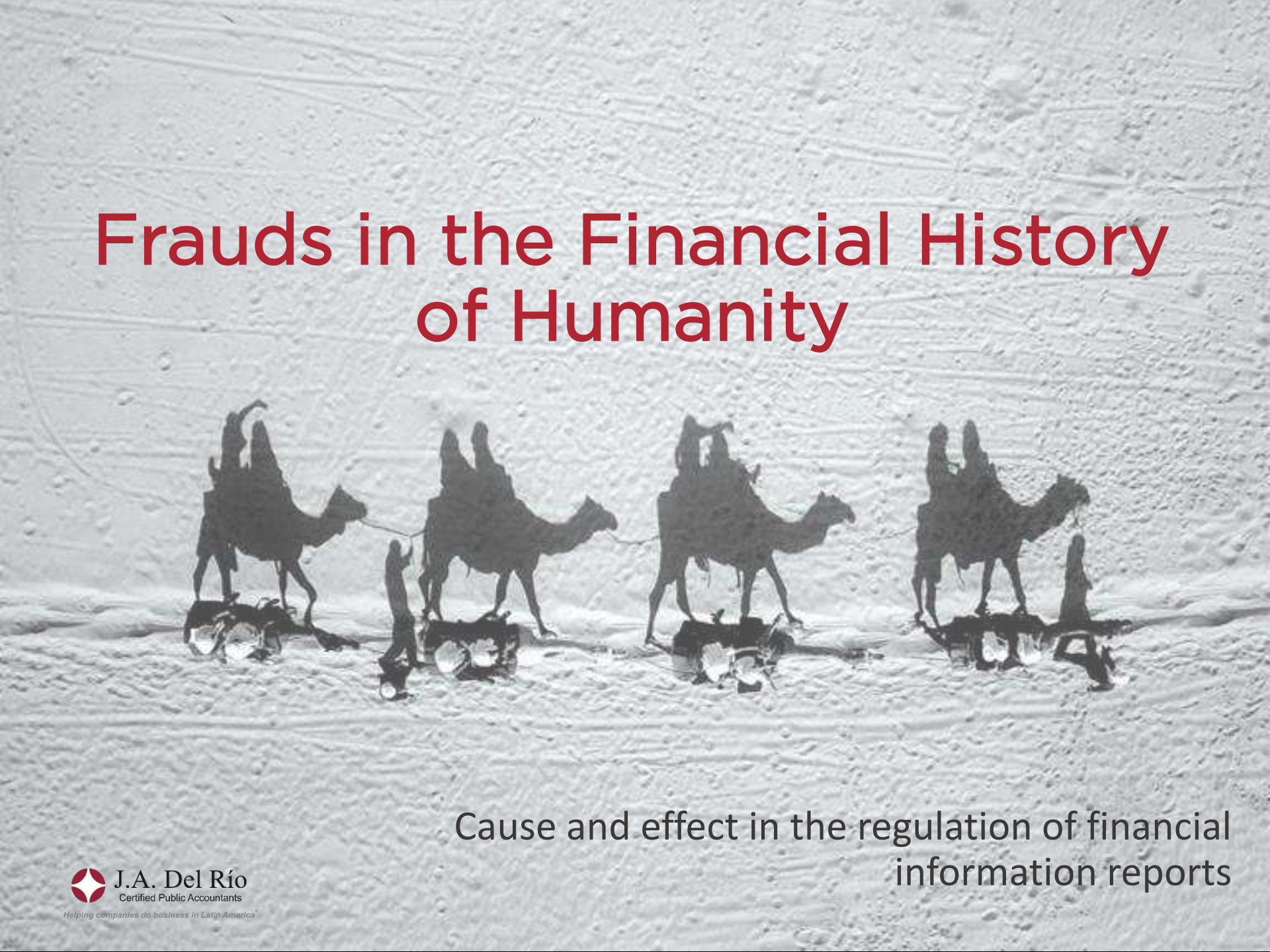
Other names for accounting fraud

- Creative Accounting /Earnings management
- Aggressive accounting
- Earnings manipulation
- Rigged accounting
- Income Smoothing:
  - Alteration of the year in which the transaction is carried out
  - Allocation of expenses or income throughout different periods
  - Place in which the entry is classified

Other names for accounting fraud

- Window dressing
- Big bath and cookie jar- supply management
- Impression Management – submit the accounts with data and graphs that emphasize what is positive and hide what is negative

Frauds in the Financial History of Humanity



Cause and effect in the regulation of financial information reports

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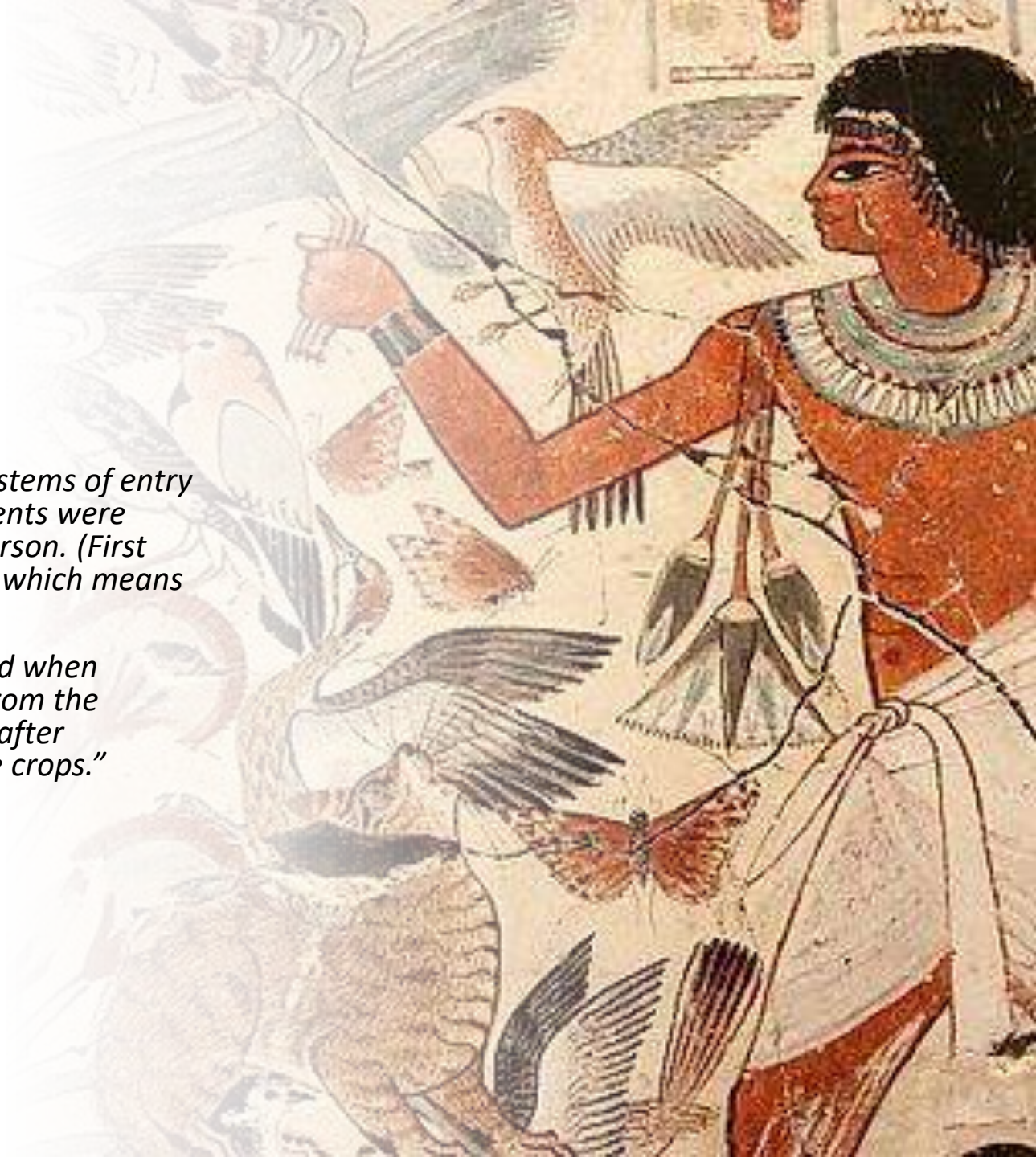
Ancient Egypt, Babylon and India

"There were orally controlled systems of entry and exit of stocks, since movements were explained to tax inspectors in person. (First audits – from the latín "audire", which means to hear.)

Accounting fraud was committed when officials and transcribers, sent from the temple, kept a part of the taxes after modifying the earnings from the crops."

Oriol Amat

Companies that lie



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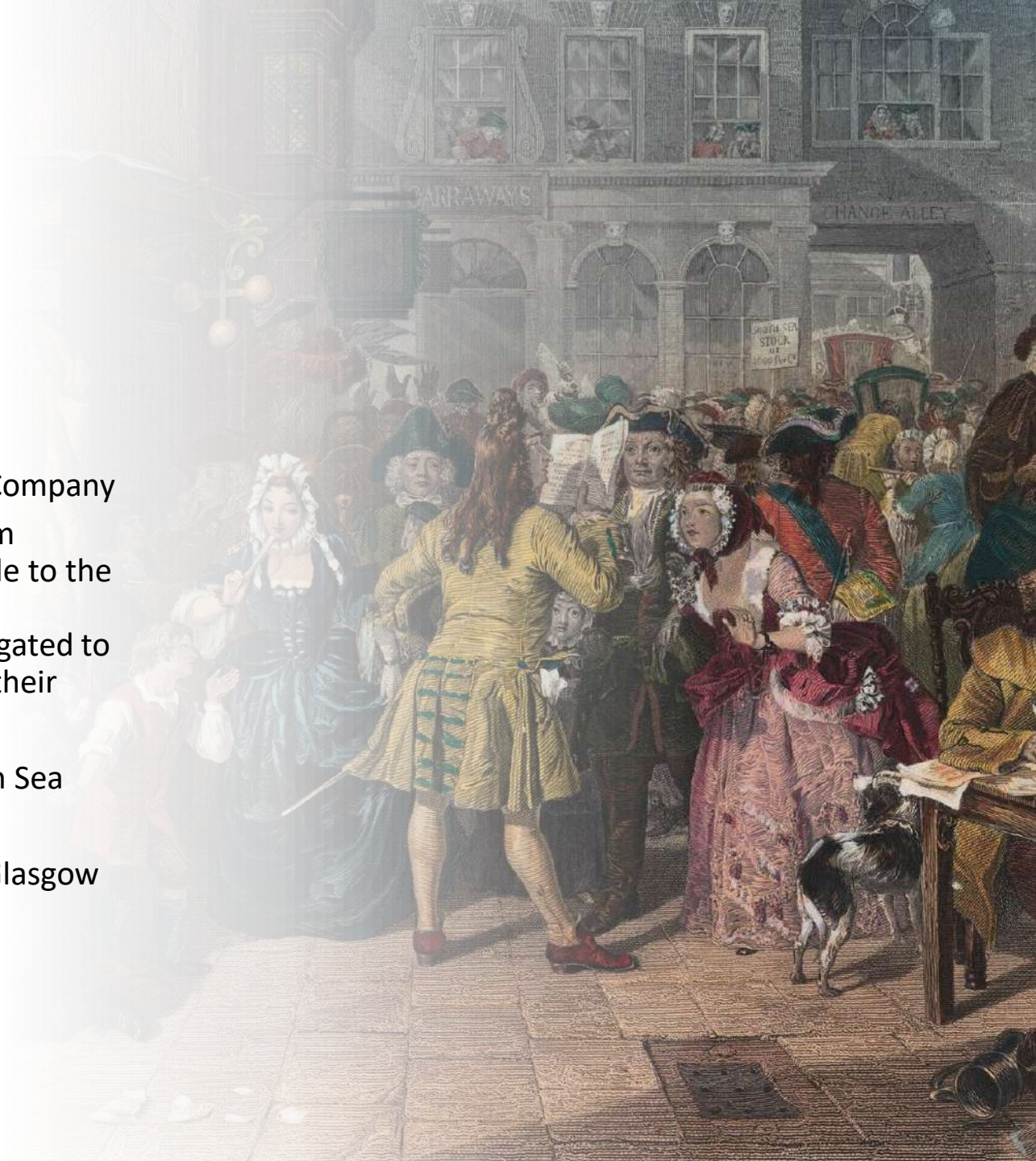
The origin of international markets

- 1602 – The Dutch East India Company
  - In 1622, complaints from shareholders were made to the authorities. As a result, companies became obligated to provide information to their shareholders
- 1853 Bankruptcy of the South Sea Company
- 1878 Collapse of the City of Glasgow Bank



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The origin of international markets

- Some companies voluntarily began to employ auditors to ensure that there could be no deceit in the accounts.
- Starting in 1880, Scottish and British capitalists who had invested in North American stock markets sent their auditors to guarantee that the balances provided by companies were accurate.
- As of 1930, listed companies in the United States were obligated to disclose their accounting reports and to submit them for an external audit undertaken by a CPA.

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The effects of "The Great Depression"

- McKesson & Robbins 1938 – overstated inventories and accounts receivable for 10 years.
  - 1941 the SEC indicated the obligation for auditors to include the confirmation of balances with third parties and the physical verification of the existence of tangible assets.
- In 1968, Bar Chris Construction Corporation showed a significant impairment between the year-end date and the date the audit report was published.
  - The obligation to evaluate subsequent events that could modify the image offered by the figures at the closing date was introduced in the audit report.

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Enron and The New Millenium (2000)

The credibility of accounting and auditing is questioned

- A pinprick in the dot-com bubble
- WorldCom
- Global Crossing
- Tyco
- Xerox
- Parmalat

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"Everything has failed"

Harvey Pitt – President of the SEC stated in 2002:

Accounting irregularities have been hidden, balances have been overstated … it is a flagrant deceit perpetrated by those in charge of companies… an almost absolute mistake from those who should have avoided it, auditors, boards of directors, lawyers, and government regulators."

Oriol Amat – Companies that lie

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The Sarbanes-Oxley Act of 2002

- The United States modified its commercial laws
- Audit regulations were amended in many countries
- The PCAOB was founded – it became the auditor of other auditors
- Adoption of International Financial Reporting Standards in many countries (IFRS)
- 2004 - The European Union opts for the application of IFRS for publicly traded organizations

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The housing bubble of 2008 and the emperor's new clothes

- Lehman Brothers
  - Transfer of subprime loans of clients to subsidiaries in the Cayman Islands
- Reformulation of financial statements of public companies between 2006 and 2009
  - Low quality rating of assets and debt
  - Incorrect estimate of income
  - Deficiencies in risk information

Would you lie to your physician?

The auditor's responsibility

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Difference in expectations

The objective of an audit is to increase the level of trust among the users of financial statements drafted by the administrators

The opinion of the auditor concerns the evidence he/she obtained, concerning the financial statements as a whole, which must be free of errors owing to fraud or mistake

The users of financial statements usually have a different perception, hence the question “Where were the auditors?” when an accounting scandal occurs.

What one and the other understand

- The faithful image of the assets and liabilities according to auditors is the adherence to accounting standards and prevailing legislation, that is, the findings seen plainly as a framework of standards that can vary from one country to another for the same economic entity.
- The PCAOB controls audit quality, common shortcomings are related to the evaluation of internal control, accounting estimates, and sampling.
- Fees vs. quality
- Independence
- Rating agencies and market expectations

Regulators ask for more…

- In every period of economic recession new regulations are approved, aimed at preventing repeat fraud
- Financial information has limitations
  - Acquisition cost
  - International accounting differences
  - Intangibles
  - Regulatory complexity

NIA 240 – Accounting frauds

- Manipulation, falsification, or alteration of accounting records
- **Misrepresentation or intentional omission** of events, or other significant information from the financial statements
- **Intentional misapplication** of accounting principles

The perpetrators

Motivation: Need or pressure that encourages interest in defrauding

Opportunity: A situation that allows fraud with a low risk level

Rationalization: A frame of mind that justifies a person committing fraud

Profile of fraudster

Capability

Arrogance

Intentions

Fraud and income smoothing

- In both cases there is an intent to deceive.
- Often, both are in response to the company's financial difficulties.
- Accounting manipulation distorts financial statements and alters the opinion concerning the financial information that users have.
- Both damage confidence in the system and can impede steady progress in the economy and financial markets.

How is it done?

- By increasing or reducing assets
- By increasing or reducing debts
- By increasing or reducing benefits

Recording fictitious sales is one of the most widespread accounting frauds.

Transactions made through tax havens- lack of regulation for preparing/reporting financial information.

Don't tell me how not to…

- **Personal red flags:**
  - Before fraud is committed, motivation and opportunity are associated with personal warning signs
    - A very aggressive incentive system for senior management
    - Poor control mechanisms
  - After the fraud is committed, the signs are quantitative and can be found in the financial states
  - Anonymous reporting
  - Coincidence – sick leaves or personal holidays, for example.

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Warning signs before the fraud

Personal

- **Motivation**
  - Significant dependences
  - Financial situation
  - Bonuses with very aggressive objectives
- **Opportunity**
  - Strong relationships with suppliers or clients
  - Conflicts of interest with clients or suppliers
  - Seniority that creates trust and many responsibilities without any controls

Racionalization

People who consider themselves to be poorly paid

Lack of motivation

Personal profile

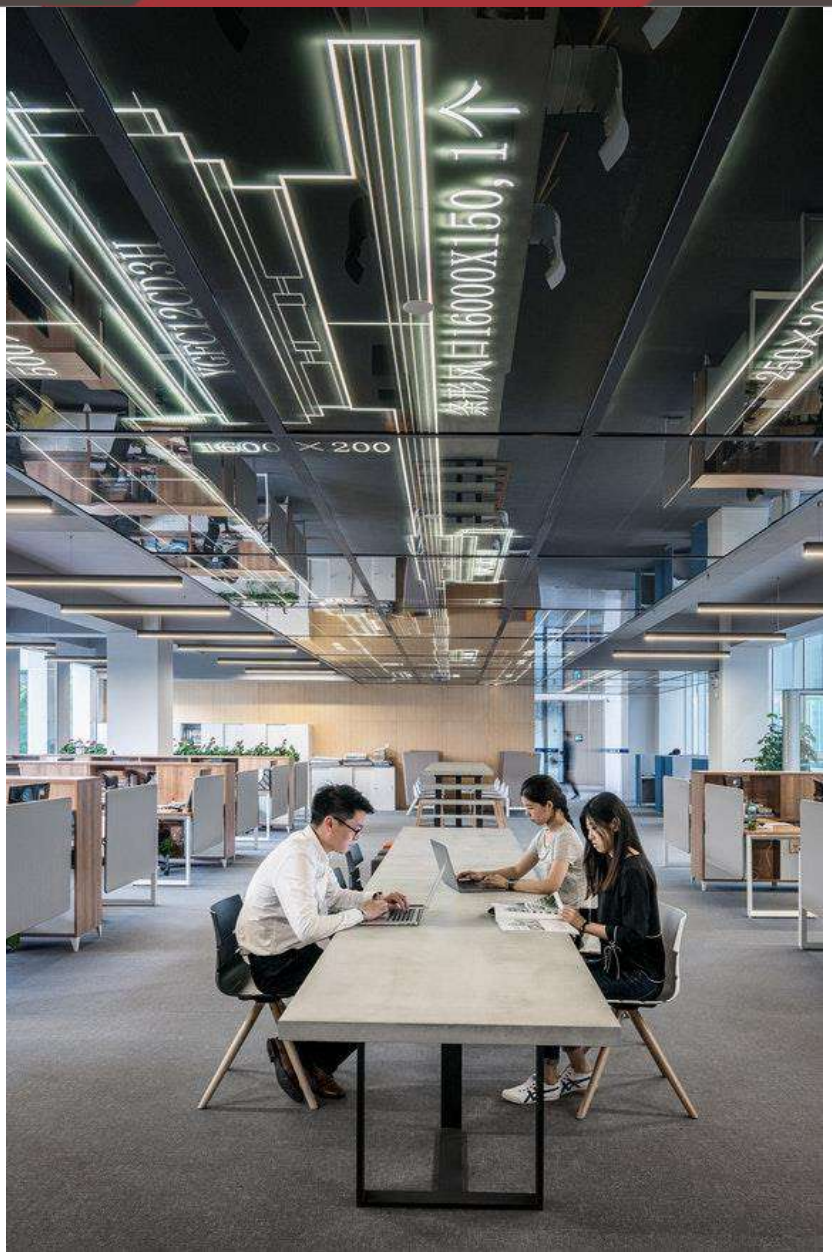
Management has a history of fraud

They're like scorpions: "never alone"

Luxurious lifestyle

Self-centered, authoritarian, aggressive and/or unscrupulous

"Drunk with success"

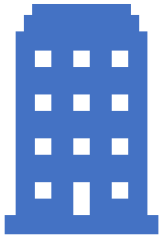


Organizational Structure

- **Causes to improve:**
  - Financing difficulties and “covenants”
  - Opinion of analysts and rating agencies
  - When managers are going to leave the company soon
  - Companies to be sold
- **Causes to decline:**
  - Paying less taxes
  - Holding off demands for wage increases
  - Change of management - mistakes from a previous administration
  - Conflicts between shareholders

Organizational Structure

- **Opportunity**
  - Lack of monitoring
    - Absence of internal or external audit
    - Companies with internal control problems
    - No adequate segregation of duties
    - Decentralized companies
    - Subsidiaries in Tax Havens
    - Inexperienced auditor
    - Relaxing controls due to a lack of auditing
    - No anonymous whistleblowing reporting channels
    - No code of ethics or professional conduct outlines



Reasoning:

The need for financing to continue as a going concern

Senior management sends signals of being unethical, which promotes this behavior in its employees

Profile:

Highly competitive sectors

Sectors experiencing recession and business closures

Highly volatile sectors

Regulated sectors

Family-owned SMEs

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Fraud clues

After the fraud, be wary of:

- A high turnover of key employees
- Frequent changes in legal advisers
- Tensions or conflicts with the auditor
- Voluntary change in auditor without just cause, or frequent changes
- Withholding of information from auditors, unclosed audits for an indefinite period
- Tax penalties
- Inappropriate relationships among company employees and auditors

Do the numbers lie?

Non-financial indicators

- Sales/points of sale
- Sales/square meters of point of sale
- Sales/number of employees, salespeople, distributors
- Cost of sales/square meters for manufacturing
- Cost of sales/number of employees

If numbers could speak

- The audit is not infallible, but you have to read the opinion.
- Auditors, including users, of financial statements must use analytical procedures to assess red flags and risk factors that may be an incentive to commit fraud.

What the balance tells…

Sales of assets recorded as loans to partners

Complex transactions with related companies

Large amounts on deferred tax assets

Excess accounting records at year's end

Discrepancy between variations in customers, stocks and suppliers, regarding the evolution of sales and purchases

… and the income statement replies with.

An unsual reduction or increase in sales with respect to the market and competitors

A reduction in orders = a decline in sales

Inconsistencies between sales and collections

An unusual increase or decrease in operating margins ***("non-standard items")***

Policy changes in capitalizing of expenses

Policy changes in recognition of expenses and revenue

… and the income statement replies with.

Recording of expenses and losses charged to reserves

Asset impairment manipulation

Services that do not create tangible results

Non-compulsory expenditures

(non-deductible)

Sale of Assets

Questionable or excessive transactions with related parties

Other indicators

- Cash flow - marked discrepancy between cash flow (EBITDA) and the flow from operating activitiesAdjustments concerning changes in accounting policies
- Adjustments for changes in accounting criteria
- Off-balance-sheet transactions – non-recourse factoring
- Transactions that make no economic sense
- Unjustified changes to ratios
  - Liquidity
  - Indebtedness
  - Term or business cycle (collection, payment, inventory)
  - Asset turnover

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Q&A Session