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Coverholder at LLOYD'S

Fraud and Accounting Scandals

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Corporate Collapses and Scandals

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Corporate collapses and scandals may or may not affect you and your company, however the ones that do could prove to be very devastating and have a catastrophic effect, especially if there is an insolvency or bankruptcy.

As a credit manager, financial analyst or underwriter these thoughts are enough to keep you up at night.

- Accuracy of the information
- What if the financial statements are wrong
- If there is a misrepresentation, is it unknowingly or on purpose

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Fraud & Bankruptcy

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- "Many of the companies that commit financial statement fraud are dealing with adverse performance issues and committing fraud to cover those up."
- A significant proportion of them, 20 percent will end up filing for Chapter 11 (bankruptcy protection). Toby Bishop, director of the Deloitte Forensic Center.

- Fraud-linked bankruptcies like Enron, WorldCom, and Adelphia have kept U.S. courts busy for years. Companies that were cited for financial-statement fraud were twice as likely to file for bankruptcy as those that were not cited. AccountingWEB

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Alarming Numbers

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- More than half of U.S. organizations that experienced fraud in the past three years reported an increase in the number of occurrences, according to a report by PricewaterhouseCoopers (PwC) data. It also found a rise in accounting fraud, bribery and corruption, with cybercrime moving to the forefront of U.S. companies' concerns.

- PwC US found a continuing upward trend in the frequency and detection of economic crime, according to the Global Economic Crime Survey 2014. About 45% of organizations in the U.S. reported being victimized in some type of fraud in the past two years, more than the global average of 37%.

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Wave of Scandals

Although accounting fraud has happened throughout the years there was a wave of scandals that happened in the early 2000's with some notable ones that ended in bankruptcy.

Enron

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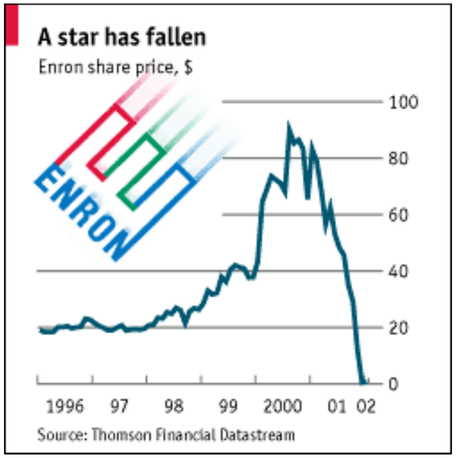
- **Enron:** A global gas and oil product manufacturer.
  - It was believed that Enron was highly profitable, because the company's energy commodities were so heavily traded.
  - In 2001 the SEC noticed irregularities in Enron's financial statements. Enron was booking round-trip trades, with prearranged buying and selling agreements where they would sell and buy back the commodities at the same price, and no actual profit was recognized.
  - Heavy trading enticing investors to buy the company's stock.
  - Substantial bank borrowings that were channeled through other Enron made up companies and were made to look like the borrowed funds came from substantial trading deals.
  - Investors withdrew, and in December 2001 Enron
  - filed for bankruptcy protection.



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WORLDCOM

- **WorldCom:** an American telecommunication corporation.
  - Was met with failures in its long distance telephone ventures, due to technological advancements in communications.
  - Hit with falling stock prices and a failed share buyback scheme.
  - It was found that directors used fraudulent accounting methods to push up the stock price.
  - Their internal audit team found irregular accounting entries which ultimately spurred an SEC investigation.
  - There was $11 Billion in fictitious A/R entries.
  - Stockholders pulled out their investments and WorldCom filed for bankruptcy in July 2002.

Parmalat

- **Parmalat:** a multinational Italian dairy and food corp.
  - Entered into the world's financial markets after it made several international acquisitions, financed with debt.
  - Many of their divisions were producing losses.
  - Started to use the derivative market with the intention of hiding losses and debt.
  - Planned on raising 300M Euros thru new bond issuance and this was surprising to the markets, the bond issuance was dropped but public concerns raised over transactions with a mutual fund Epicurum, a Cayman based company caused their shares to significantly depreciate.
  - Without funding and cash needed to pay debts and bond payments Parmalat filed for bankruptcy protection in December 2003.

Sarbanes-Oxley Act

- High profile public cases that had financial scandals and fraud in the US mounted in the early 2000's including others like Tyco and Adelphia Communications.
- Investors lost faith in in the audited reports they were looking at. US Congress stepped in and passed the Sarbanes-Oxley Act in July 2002 (also known as SOX) to protect shareholders and the general public from account errors and fraudulent practices, as well as improving the accuracy of corporate disclosures.

  - The SEC administers the act, which sets deadlines for compliance and publishes rules on requirements.
  - The SOX act not only affects the financial side of corporations, but also the IT departments charged with storing a corporation's electronics records. It defines which records should be stored and for how long.

Increased Technology, Increased Risk

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- As organizations rely more on technology, they increasingly do business in a "borderless economy" where they are more susceptible to threats from all sides. PwC

  - Watch out for internal perpetrators of fraud, but also remain wary of the external perpetrator.
  - Fraud at U.S. organizations initially detected by external measures or by accident in 2014 more than doubled from 2011 levels: 32% in 2014 compared to 15% in 2011, and was initially detected through external tip-offs more often than any other method. (Accounting Fraud on the Rise at US Companies)

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SEC's Stepped Up Action

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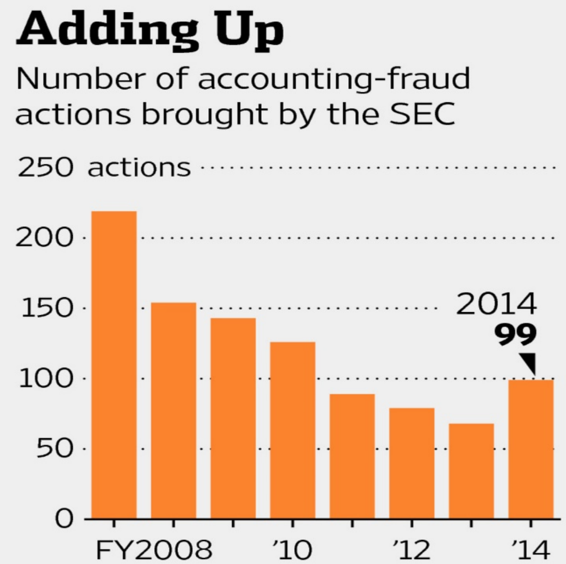
- In the US the SEC's push to step up its policing of accounting fraud has led to a surge of cases and investigations.

- New agency figures show an upturn, the SEC's first year-over-year increase in such enforcement actions since 2007, up 46% from 2013.

- The new cases are on a smaller scale and typically involve conduct that is far less egregious than the accounting scandals of the early 2000s, such as the implosion of energy giant Enron Corp.



Note: Pre-2011 numbers also include actions under the Foreign Corrupt Practices Act. Fiscal year ends Sept. 30.

Source: Securities and Exchange Commission

The Wall Street Journal

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SEC Sanctions

- None of the recent accounting-fraud cases have been blockbusters, but the SEC has been issuing sanctions:

- **CVS Caremark Corp:** paid $20M last year to settle allegations of misconduct including improper acquisition related accounting adjustments that boosted reported earnings in 2009.
- **Bank of America Corp:** paid $20M in August 2014 to resolve their part of its $16.6B mortgage settlement with the government. BofA admitted failing to disclose uncertainties about potential higher costs related to mortgage-repurchase claims.
- **Diamond Foods Inc.:** paid $5M in January 2014 to settle charges it had boosted earnings by not recording all of their costs.

Common Types of Fraud

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- Fraud does not discriminate against any specific country or business sector, as it is borderless and is done with the intent of deceiving its investors.

– Sheila Smith, head of reorganization services at Deloitte said,
There are two distinct groups of people who are engaging in these frauds:

  - the people who are attempting to prop up the company in the hopes that the bank gives them more liquidity
  - those that are doing it more for their own personal benefit

The most common type of fraud detected at both bankrupt and non-bankrupt companies was improper revenue recognition. Followed by improper disclosures and manipulation of expenses also showed up frequently in both groups. (Fraud and Bankruptcy Go Hand in Hand)

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OW Bunker case

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- **OW Bunker:** The Danish Fuel Trader founded in 1980, was one of the world's largest Marine Fuel Traders that operated in 29 countries went from an IPO to bankruptcy in eight months.
  - Although their business was considered a low margin, the high volume was attractive to many.
  - OW Bunker went public in March 2014 and quickly amassed 20,000 new shareholders and the company value got close to $1Billion on the NASDAQ OMX Copenhagen exchange.
  - The IPO was believed to be a success, but after the spring season derogatory news surfaced in early October 2014 about weak profit warnings due to unrealized account loss before tax, triggered by the slide in oil prices of about $24M.
  - By the 5th of November the OMX shares were suspended from the NASDAQ, and on the same day OW Bunker management declared a loss of $275M.

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OW Bunker case

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- There were two separate issues behind the OW Bunker scandal:

  - A fraud was discovered, schemed by senior employees in a previously unknown Singapore subsidiary named Dynamic Oil Trading, resulting in $125M in loss.
  - A “risk Management loss” in addition to the $24M already mentioned above found after a review of “OW Bunkers risk management exposure” the total loss was estimated at $150M.

With this information, their lending partners pulled back on their credit lines and with no other viable solution, OW Bunker filed for bankruptcy protection on the 7th of November 2014 in Denmark, and other filings in the following days in other jurisdictions and countries.

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OW Bunker case

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The most alarming part of the OW Bunker case was the fact that this was a recent IPO and their records and books were being scrutinized by their lending facility and banking consortium, legal professionals, as well as auditing firms going over all of their records in detail in efforts to present their IPO prospectus.

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Under Investigation

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- **Tesco PLC:** a British multi-national grocery retailer. Founded in 1919, it is the second-largest retailer in the world based on revenues and has stores in 12 countries throughout Europe and Asia.

  – In September 2014, Tesco announced it overstated first-half profits by about $424M, blaming incorrect booking of payments from suppliers.

  – The Financial Conduct Authority originally spearheaded investigations, but the Serious Fraud Office (SFO) in the U.K. stepped in, classifying it as a criminal investigation focusing on accounting irregularities.

  – Tesco was accused of bringing forward payments to make their financial results better as sales fell.

  – The SFO is now looking at Tesco's audited results for the past four years, including the role of its auditing firm. Expected fines are in the area of $700M.

  – In February 2016, Tesco agreed to pay $12M to settle a US lawsuit, due to suffering ADR losses (American Depositary Receipts) from NY. Another suit is coming from OH, as well.

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Under Investigation

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- **Toshiba Corporation:** a global Japanese electronics, parts and component manufacturer, dating Back to 1875.

TOSHIBA

Leading Innovation

  - In July of 2015 an accounting scandal tied $1.3 Billion in overstated operating profits, over the past seven years. The report reveled that CEO's placed immense pressure on subordinates, and waited for the corporate culture to turn out the results they wanted.
  - Dating back to 2008 under one CEO and continued thru two other CEO's to 2015.
  - Found evidence of booking future profits early, pushing back losses, pushing back charges and other overstated profits.
  - Company leadership handed down strict profit targets, aka: Challenges, to business presidents, often with the implication that failure would not be accepted.
  - A corporate culture, demanded obedience to superiors, was an important factor enabling the emergence of fraudulent account practices.
  - December 2015 announced cutting 7,000 jobs, selling its Indonesia TV facility and expects losses of $4.53 Billion for YE March 2016.

How can Credit Professionals Prepare

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Two of the most important areas to consider are the strength of a company's credit team and the relationships it has with its customers.

- Credit Analysts that can dissect, collate and decipher information into an easily readable format, can track trends, that may help to spot early warnings of possible irregularities.
- Build strong relationships with customers to fully understand their business process, needs and customer base.
- Look deeper into the supply chain and risk management procedures.
- On client visits, pick up visual clues that could help you in your credit assessment.
- Don't be afraid to ask questions, specifically

opened questions.

- Look for Red Flags.

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Red Flags

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- Catlin Glass a forensic analyst with Forensic Strategic Solutions, Inc. says a good forensic accountant or investigator could help you, but there are some red flags to look out for.
  - Complex webs of relationships (usually business relationships)
  - "Insider" vendors and/or vendors with extensive connections to the company
  - Unusually high sales per employee compared to peer group
  - Patterns in the financial transactions
  - Lack of information
  - Missing assets
  - Poor record keeping
  - Extensive cash activity
  - Spikes in insider trading

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Securitization Alternatives

- The forensic red flags are great advice, and key areas to look for. But in reality they are very hard to spot.
- Michael Maloney, chief accountant in the SEC's enforcement division, said financial fraud is now "in many cases, harder to detect" than those earlier scandals.

- Alternatives that are available to combat uncertainty, and provide securitization.
  - Selling receivables to a banking or financing facility
  - Trade Credit Insurance
  - Floor Planning, or Factoring
  - PUT Option

Are all solutions that can provide beneficial security to protect your company's assets against customer Default, Uncertainty, and Fraud.

Closing Summary

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- Fraud is unpredictable and is difficult to spot the signs until it is too late
- Fraud is devastating and can have a catastrophic effect
- Business today is in a "borderless economy" where they are more susceptible to threats from all sides
- Credit professionals can prepare to help better spot warning signs
- There are securitization alternative available

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