

One basic concept in accounting states that every transaction consists of two equal parts. This equilibrium is intended to create a system of checks and balances within the accounting records. For example, when an expense is recorded, a liability is incurred for the same amount. When the expense is paid, the liability is removed from the books and cash is decreased by the same amount. The first example affects the income statement and the balance sheet, while the latter affects only the balance sheet.

Within this system of checks and balances, slick financial cheats maneuver the books to their advantage. Generally, those who review financial statements focus on the income statement. We believe, often too frequently, that revenue growth leads to net income growth, but this is not necessarily true.

While keeping an eye on company revenues, we tend to lose focus on balance sheets and cash flow statements, both of which are equally important. WorldCom's CEO Bernie Ebbers, a former milkman and a nightclub bouncer in college, understood all too well how investors can become infatuated with revenue growth. WorldCom's scam, despite its magnitude was surprisingly simple. Consider the following example:

	Before	Fraud	After
Income Statement			
Revenue	\$ 1,000		\$ 1,000
Operating expenses	<u>1,200</u>	<u>500</u>	<u>700</u>
Net income (loss)	<u>\$ (200)</u>	<u>\$ 500</u>	<u>\$ 300</u>
 Balance Sheet			
Assets	<u>\$ 2,000</u>	<u>\$ 500</u>	<u>\$ 2,500</u>
Liabilities	1,500		1,500
Shareholders' equity	<u>500</u>	<u>500</u>	<u>500</u>
Total liabilities and equity	<u>\$ 2,000</u>	<u>\$ -</u>	<u>\$ 2,000</u>

In this example, it appears the company lost \$200. Since we did not like this result, we changed it by reducing operating expenses by \$500. As discussed earlier, our accounting dual recordation system requires us to offset this \$500 amount. Assets are usually chosen in fraudulent schemes as a place to hide money.

Assets are treated differently than expenses.

When we buy assets we “capitalize” them. They are held over a period of time and then written off slowly. In our example, we have increased assets by \$500 to prop up net income.

Now, replace the \$500 above with \$9.5 Billion, \$9,500,000,000 (give or take a few hundred million) and you have WorldCom's scam. A simple five-year plan of capitalizing labor and fees paid to third parties, along with computer expenses, a major expense for telecommunications companies, led to the deception. WorldCom simply placed those expenses on the balance sheet, an action that effectively hid the real operating results of the company.

This action allowed WorldCom to post a record \$1,380,000,000 profit in 2001 and landed Bernie Ebbers on the cover of Business Week, where he was lauded “The Telecom Cowboy.”

Where did the money on the balance sheet go? The money is usually hidden in places you would not normally review as carefully as a revenue item. Accounts selected for inflation most often include:

- ✓ Intangible Assets;
- ✓ Buildings and Improvements;
- ✓ Inventory;
- ✓ Investments in Company X, Y, Z, etc.; and,
- ✓ Prepaid expenses.

On a smaller scale, the same type of “balance sheet loading” occurs as well. There are some distinctions between smaller, closely held companies and multi-national corporations.

Investors are focused on return on investment; they are always looking for payments to themselves for the cash they paid into the company. Loading the balance sheet works for a while; however, unlike WorldCom, local investors notice when an investment in assets such as buildings and equipment grow beyond reasonable limits. When a building that appears on the balance sheet never graces the skyline, it tends to raise red-flags within a local or regional company. To avoid calling attention to large discrepancies, the balance sheets must also involve writing-off all accumulated assets before the error becomes noticed. This drastic action requires a more complex form of fraud. The following is an example of financial statement fraud engagements we have uncovered in smaller companies.

Can you spot the fraud in this example?

	THIRD QUARTER			
	Qtr 3		This Year's Year to Date	Last Year's Year to Date
	This Year	Last Year		
Income Statement				
Revenue	\$ 1,000	\$ 875	\$ 3,350	\$ 3,000
Cost of Goods Sold	500	450	1,670	1,550
Operating profit	500	425	1,680	1,450
Expenses	300	255	950	900
Net income	\$ 200	\$ 170	\$ 730	\$ 550

This is a typical financial statement showing the quarterly results compared to last year's results and the year-to-date's results compared to last year's results over the same period of time.

	FOURTH QUARTER			
	Qtr 4		This Year's Year to Date	Last Year's Year to Date
	Last Year	Last Year		
Income Statement				
Revenue	\$ 975	\$ 900	\$ 4,350	\$ 3,750
Cost of Goods Sold	485	480	2,250	2,000
Operating profit	490	420	2,100	1,750
Expenses	265	255	1,275	1,250
Net income	\$ 225	\$ 165	\$ 825	\$ 500

By analyzing the company, we can see that in the third quarter, revenue has grown to \$1,000 from last year's \$875. In addition, revenue has grown on a year to date basis as well. Revenue is up from \$3,000 in the prior year to \$3,350 in the current year.

This is good, isn't it?

Your example has 4th qtr LAST year twice

In the fourth quarter, the trend continues. Revenue is outpacing last year's fourth quarter \$975 to \$900, and operating profit for both the quarter and year are up as well.

What is the problem? First of all, the layout of the financial statement is positioned vertically. It contains a lot of valuable information in addition to comparisons to the prior periods that help us analyze the company's performance. Despite this plentiful offering of information, the numbers simply do not add up. Net income (NI) at the end of the year is merely:

✓ Q1 NI + Q2 NI + Q3 NI + Q4 NI = Year to date net income

In this example, as in most financial statements, we do not have all four quarters nicely laid out for us to add together. Instead, we have the third quarter's results and the fourth quarter's results, listed independently of each other. If we take the year-to-date third quarter results, which should be Q1 + Q2 + Q3 and add them to Q4, our numbers come out differently than the presentation above suggests.

FUNNY MATH					
	Qtr 3 This Year's Year to Date	This Year's Qtr 4	Qtr 4 YTD Should Have Been	Qtr 4 YTD as Stated	Fraudulent Changes
Income Statement					
Revenue	\$ 3,350	\$ 975	\$ 4,325	\$ 4,350	\$ (25)
Cost of Goods Sold	1,670	485	2,155	2,250	(95)
		+	=		
Operating profit	1,680	490	2,170	2,100	70
Expenses	950	265	1,215	1,275	(60)
Net income	\$ 730	\$ 225	\$ 955	\$ 825	\$ 130

Looking at the table above, we can see that the year-to-date net income in the fourth quarter should have been \$730, Quarter 3's year-to-date net income plus \$225, Quarter 4's net income equals \$955 year-to-date at the end of the year, the fourth quarter. The fraudulent employee has instead started net income at \$825, a difference of \$130.

This offense occurs by taking charges to prior quarters after those financial statements had already been released to the investors. In order to approximate how these results would fare for a local company, multiply the \$130 by \$1,000 per quarter (\$130,000 per quarter missing) and you have someone stealing over \$520,000 per year.

When you consider that approximately three months would have passed between the third quarter's statement and the fourth quarter's statement, the deception is hidden fairly well. Had the postings occurred in the fourth quarter, enabling our year-to-date formula to work properly, the profit for the fourth quarter would have only been \$225, as originally stated. After subtracting the \$130 deception, \$95 remains. This larger error might have caught the investors' attention. Since people rarely check for accuracy in prior quarters, the fraudulent employees chose to hide their offense in the year-to-date totals.

Our fraud examination experience has taught us that investors and partners in companies should carefully review all aspects of the financial statements they are given. Pay attention to:

- ✓ Trends in asset growth;
- ✓ Results posted in prior period statements; and,
- ✓ Line items you do not fully understand.

Most frauds begin with small amounts and then balloon into losses up to hundreds of thousands or even millions of dollars. Although WorldCom made national headlines with their outrageous accounting tricks, a seemingly difficult feat, many local companies fall victim to the simplicity of Bernie Ebbers' guiding accounting principles.

Frank Wisehart CPA, ABV, CFE, CVA is President of Wisehart & Wisehart, Inc. a firm specializing in forensic accounting, fraud and expert testimony. Mr. Wisehart is also an MBA candidate at Cornell University