

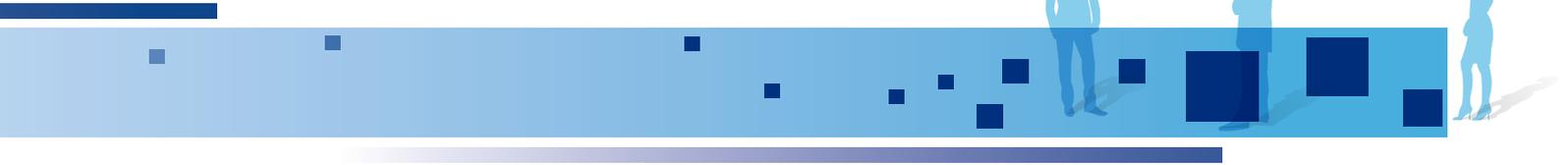


Corporate Failures

Forensic

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Executive summary

Fraud does not always result in corporate failure, nor do corporate failures occur only as a result of fraud. However, in some of the biggest corporate failures across the globe, fraud was involved. No single model can successfully predict the risks of fraud or the fact that fraud is occurring or has occurred.

Much research has been done globally to measure fraud, many articles have been published recommending additional mechanisms to prevent and detect fraud. Court sanctions of convicted fraudsters do not appear to deter and additional legislation and regulation appear to have little impact in reducing the occurrence of fraud and, hence, corporate failures.

The research, conducted on nine case studies across the globe, revealed various commonalities in some of the biggest corporate failures due to fraud, namely:

- Greed or sense of making magic happen
- Over-ambitious corporate expansions leading to complex structures
- Excessive debt to fund expansions or personal expenses
- Incentives to management increase the motivation to commit fraud
- Pressure to achieve market expectations
- Corporate governance failures as a result of incompetent or ineffective boards and board committees
- Sense of entitlement by senior management

- Failure and override of internal controls
- Manipulation of financial records and/or fraudulent financial reporting to disguise the true nature of underlying problems

The main theme that was observed throughout the research is that a variety of role players, factors and circumstances culminated into these corporate disasters. The following summarises the main themes observed in the case studies.

The role of the auditors

Auditors have been criticised, investigated and taken to court. Many articles were written in attempts to understand the role that auditors played or didn't play and whether they should have known that fraud was occurring within the organisation. The independence of relationships between clients and auditors have come under scrutiny. The quality of audit work performed was considered to be of less than desirable standard where corporate failures occurred.

Finally, consideration has also been given to the expectation that auditors should identify fraud and whether that expectation is realistic.

M Bhasin, author of *“Corporate accounting scandal at Satyam: A case study of India’s Enron”*, stated that audits would only detect approximately 10% of frauds. The Association of Certified Fraud Examiners maintains that audits are ineffective although it is the most widely used mechanism to detect fraud and prevent losses.

Bridging the expectation gap is therefore a process of creating awareness among investors and shareholders of the scope of the financial statement audit and the value it provides as well as what it cannot provide. Auditors are not required to analyse all non-financial data of a company, some of which could indicate fraud risks.

Corporate governance failures

Corporate governance was also touted in many instances as the main reason for corporate failures. Attempts at curbing these failures in the form of more stringent legislation and regulation does not appear to have had the desired impact. Due to the various causes of corporate failures, corporate governance failures cannot be regarded as the sole contributing factor to corporate failures.

The case studies revealed numerous governance issues, including inter alia the following:

- Non-independent board and audit committee members, for example where a CEO fulfilled multiple roles in various committees
- Inadequate governance structures, for example, lack of board committees or committees consisting of a single member
- Inappropriately qualified members, for example, family members holding board positions or audit committee members not having appropriate accounting and financial qualifications or experience to analyse key business transactions
- Ignorance by auditors, regulators, analysts etc of the financial results and red flags
- Management, who deliberately undermines the role of the various governance structures through the circumventing of internal controls and making misrepresentations to auditors and the board

It therefore appears that more regulation has not resulted in more effective governance over corporates.

Implementing the regulatory and best practice guidelines for good corporate governance has been a costly and cumbersome exercise for most companies. The implementation of *“better”* governance structures has become a checklist exercise to ensure compliance.

The major risk still being observed during various forensic investigations indicates that the mind-sets of management and those tasked with governance have not really changed. Some members of governance structures are not aware of the onerous positions that they hold and the full extent of the responsibility and accountability ascribed to them.

Pressures present when fraud occurred

The pressure cooker syndrome considers the internal and external pressures that the leaders of organisations suffering corporate failures endured, putting some of the responsibility at the door of each stakeholder, banking institution, analyst and the public that missed the red flags.

The committing of fraud is intended to benefit the organisation, for example overstating profits, but may benefit management through bonuses based on profitability.

CEOs and CFOs commit accounting fraud to conceal poor financial performance, preserve their personal status and control and to maintain their personal income through performance-based bonuses.

Leaders in corporate failures

Not only have auditors been in the firing line following corporate failures. CEOs and boards have also been called to task on the execution of their duties and why fraud occurred under their management and oversight.

Leaders in corporate failures have been sentenced to jail, paid substantial fines and walked away with reputations a little less intact. Various authors have highlighted the character traits of leaders of failed corporates.

However, one transparent fact cannot be ignored and is observed across all case studies, namely a blatant belief in their own power and ability to create magic and their deliberate actions to execute such belief.

Consideration of the specific character traits that have been observed in corporate failures could provide insight into why more legislation and regulation has not reduced the occurrence of management fraud.

The nature of fraud causes

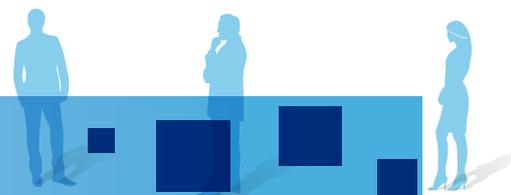
It is well known that Rudolph Giuliani ("Giuliani"), the former mayor of New York City, implemented the broken windows theory to reduce crime. Giuliani indicated that "*... you had to pay attention to small things, otherwise they would get out of control and become much worse*".

Considering the wide variety of causes observed in the corporate failure case studies, the challenge of detecting and deterring fraud is therefore not easy to solve due to the numerous role players, possible scenarios and the unpredictable nature of individuals. The obvious question is then how to apply the broken windows theory to corporates in an effort to detect and deter fraud. The various themes

identified as indicators of fraud provide insight into the various broken windows, ie:

- Non-independence of auditors
- Compromised quality of audit work due to reduced fees
- Deliberate actions and misrepresentations by management to delay or divert auditors' attention from problematic areas
- Misconception of the role of an auditor and to what extent they are able to identify fraud through their audit procedures
- Poor or lack of corporate governance despite legislation and regulation, including non-independent and inadequately qualified board or committee members, lack of debate of business issues at board level and a deliberate disregard of legislation by management
- Unrealistic expectations of stakeholders for performance and growth or the fear of management to look like a failure and thereby





disguising the true financial status of the company

- The capability of individuals to commit fraud by circumventing internal controls, using company finances for their personal benefit, dominance by the chairman or CEO and acting as though they are creating magic without feeling any remorse

Suggested solutions to pro-actively identify the likelihood or occurrence of fraud

Fraud was clearly not the reason for the corporate failures discussed earlier. Fraud was used to hide the truth of what was really happening and to convince investors and analysts that all was well. The main reasons why the companies discussed in this publication reverted to fraud were to hide excessive debt, poor strategic decisions and the fact that the company was short of cash.

Creative and aggressive accounting, fraud and coercion can disguise the truth only for a while, until the underlying problems it attempts to hide become so enormous that it cannot be hidden any longer.

Regardless of the location of the various case studies considered, the same themes emerged in corporate failures that occurred across the world. Although many articles have been written about addressing each of the above issues separately, two clear themes have emerged, being:

- Certain areas that are specifically exposed to fraud and could be exploited if the elements of the fraud triangle are present
- Specific behaviours considered in conjunction with the organisation's culture may provide indications of the organisation's vulnerability and/or likelihood of fraud occurring

Conventional forensic investigations focus on obtaining evidence regarding a known or suspected incident.

Two specific investigation strategies flowed from KPMG Forensic's Global Investigations Methodology to address the above two themes, namely Risk-Based Investigations and Behavioural Investigations.

On the other hand, Risk-Based and Behavioural Investigations are pro-active in nature and aims to identify fraud risk areas, detect incidents of fraud, establish patterns of behaviour and determine which fraud elements are receiving too little attention in order to inform the client to better understand the organisation's susceptibility to fraud.

KPMG's approach to Risk-Based and Behavioural Investigations focusses on the various elements of fraud, ie motivation/pressure, rationalisation, opportunity and capability.



Risk-Based Investigations

The purpose of Risk-Based Investigations is to identify fraud risk areas, identify incidents of fraud, and establish patterns of behaviour where there may be suspicion of irregularities, where no specific incidents of fraud have been identified or where a starting point for a forensic investigation is not immediately obvious.

Behavioural Investigations

It is commonly known that the management of any organisation is responsible to prevent and detect fraud. However, when fraud is committed by management, their ability to influence people and to disguise the true nature of the events facilitates the occurrence of fraud.

The purpose of Behavioural Investigations would therefore be to establish the behaviours manifesting in an organisation with due consideration of the code of conduct and various governance structures. The organisational culture may be enabling fraud as it promotes certain behaviours, particularly where conventional control measures are not sufficient to prevent fraud. Behavioural Investigations therefore assess those traits and others' perceptions of deviations from desired behaviour that may indicate an endorsement of inappropriate use of company assets, a culture of unethical

conduct being overlooked or even condoned and whether there is an active realisation of the organisation's and shareholders' interests. By its nature it has a predictive impact.

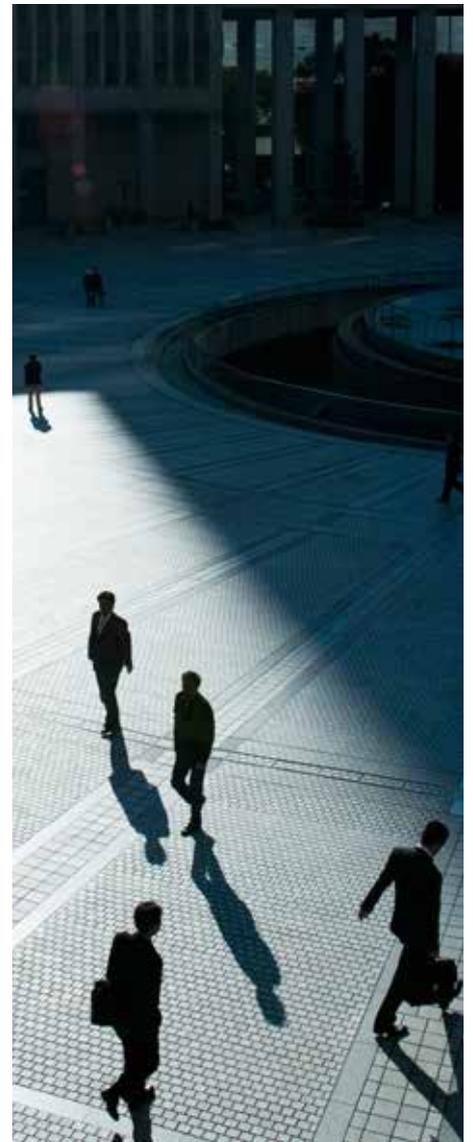
Conclusion

Not one single person, entity or body can be held responsible for fraud when corporates fail.

Rather, the collection of investors, shareholders, financial institutions, regulators, analysts and auditors need to be responsible for the prevention and detection of fraud. E Du Toit, author of *"Using financial analysis and interpretation as a foundation to comprehend financial health"* stated that *"If one accepts that fraud is always a possibility, it becomes clear why everyone, including parties external to the operations of a company, should make an effort to prevent, detect and identify cases of fraud"*.

Despite what fraudsters may believe, they have not created any sort of magic.

The truth of fraud is that it is deliberate and exploitive in a number of ways. It therefore requires a concerted effort at numerous levels to be vigilant and ask appropriate questions in order to properly unpack red flags before they are disregarded.



Introduction

Is the tooth fairy a fraud?

Humans seem to be fascinated by fraud. Some do it and eventually, so it seems, believe that they have created magic. Others stand in shocked astonishment observing the demise of companies, ensuing court cases and media blazes seeking answers, pointing fingers and never arriving at a satisfactory explanation of the chaos left behind.

We ask ourselves: How could this happen? Why did the auditors not pick up on such blatant behaviour? Who knew this was going on? What did we miss?

Most people have a very clear understanding of what is right and wrong. Are we not, after all, taught not to tell lies? Strangely enough, we as a global society are quite happy to teach our children about the tooth fairy. Why? Children accept the unpleasant task of losing part of themselves with the ensuring ramblings of parents about

a magical creature bringing money/rewards in exchange for little treasures. Is this fraud? Is this unethical? Or are we all just looking for a little bit of magic in a world that is hard to comprehend, even for adults?

Before it is said that everyone is now accused of being fraudsters, the simple analogy of the tooth fairy does create a number of interesting questions about fraud, which we will attempt to answer in this publication on corporate failures.

It must be understood that fraud does not always result in corporate failure, nor do corporate failures occur only as a result of fraud. However, in some of the biggest corporate failures across the globe, fraud was involved.

Much research has been done globally to measure fraud, many articles have been published recommending additional mechanisms to prevent and detect fraud. Court sanctions of convicted fraudsters do not appear to deter and additional legislation and regulation appears to have little impact in reducing the occurrence of fraud and hence, corporate failures.



According to Du Toit, it is not enough to analyse the quantitative information of a company to determine the risk of possible financial statement fraud but that qualitative information such as the culture of the company can be powerful predictors of financial statement fraud risk¹. Du Toit researched the various quantitative and qualitative characteristics thought to be predictors of financial statement fraud risk². Although Du Toit's research revealed a number of common themes, the non-financial information used by her to determine the risk of financial statement fraud is not readily available to the public³. Du Toit's research concluded that analysing the financial statements with the goal of identifying fraud risks is possible, however, such will not always be able to detect fraud.

Basilico et al applied five financial fraud prediction measures and considered the corporate governance elements of the Satyam corporate fraud for the 2006, 2007 and 2008 financial periods⁴.

- The fraud prediction models (ie the Z-Score and the F-Score) predicted fraudulent financial reporting during the 2007 and 2008 financial periods.
- The Sloan Accrual Measure indicated fraudulent financial reporting during the 2006 financial period.
- The Quality of Earnings Ratio indicated fraudulent financial reporting during the three financial periods assessed.
- The Quality of Revenues Ratio indicated fraudulent financial reporting in 2007 and 2008.

KPMG's global profiles of the fraudster indicated that the type of fraud and the type of fraudsters are continually changing⁵.

From the above, it therefore appears that no single model can successfully predict the risks of fraud or the fact that fraud is/has occurred.

Corporate failure can be traced back to the early 1300's and a company called Compagnia dei Bardi ("Bardi")⁶. The Bardi family founded the company. Bardi traded in oil, wine and specifically high-quality wool cloth. During 1344, Bardi was bankrupt. King Edward III

allegedly denied owing money to Bardi although he repaid some of the loans with cash and royal grants of wool.

Many centuries later, fraud and corporate failures still occur.

Various statistics are published regarding fraud but we have only highlighted a few below.

Kroll reported in its 2010/2011 Global Fraud Report that business losses due to fraud increased by 20% and that 88% of respondents from 760 companies surveyed, indicated that they had been victims of corporate fraud⁷.

KPMG's global profiles of the fraudster included an analysis of 596 fraud

matters investigated between 2011 and 2013 and revealed that the typical fraudster⁸:

- Is between 36 and 45 years old
- Generally acted against his/her own organisation
- Was mostly an employee in an executive, finance, operations or sales/marketing function
- Held a senior management position
- Was employed in the organisation for more than six years
- Acted in collaboration with others to commit the fraud

¹ Du Toit – Characteristics of companies with a higher risk of financial statement fraud: A survey of the literature

² Du Toit – Characteristics of companies with a higher risk of financial statement fraud: A survey of the literature

³ Du Toit – Using financial analysis and interpretation as a foundation to comprehend financial health

⁴ Basilico et al – Asia's Enron: Satyam (Sanskrit word for truth)

⁵ KPMG – Global profiles of the fraudster

⁶ KPMG – Corporate failures through the ages

⁷ McCartney – Where there's smoke, there's fraud

⁸ KPMG – Global profiles of the fraudster

- Displayed a sense of superiority

KPMG's global profiles of the fraudster survey highlighted, amongst others, the following statistics⁹:

- 70% of fraudsters are between the age of 36 and 55
- 61% of fraudsters were employed by the victim organisation
- 70% of frauds were committed in collaboration with others
- 74% of frauds committed in collaboration with others occurred over one to five years
- 93% of frauds were committed in multiple transactions

A recent survey of 750 investigations conducted by KPMG world-wide corresponds closely to the above statistics and revealed that:

- 37% of fraudsters are between the age of 36 and 55
- 65% of fraudsters were employed by the victim organisation
- 62% of frauds were committed in collaboration with others
- 69% of frauds committed in collaboration with others occurred over one to five years
- 90% of frauds were committed in multiple transactions

The reasons for corporate failures

The research, conducted on nine case studies across the globe, revealed various commonalities in some of the biggest corporate failures due to fraud. Refer Appendix 1 for a synopsis of the corporate failures considered in this publication.

During consideration of the case studies, various authors summarised their views on the causes of corporate failures as highlighted by the examples below:

- *"There is perhaps no more insidious drain on the overall welfare of society than greed unchecked"* – Judge Harold A Ackerman in his opinion issued in the civil case: Securities and Exchange Commission vs Sam M Antar et al
- *"The accounting fraud committed by the founders of Satyam in 2009 is a testament to the fact that 'the science of conduct is swayed in large by human greed, ambition, and hunger for power, money, fame and glory'"*¹⁰
- According to Raju's letter to the board and shareholders, the gap between actual and recorded financial results kept growing over the years and reached unmanageable proportions. He further stated that *"Every attempt to eliminate the gap failed, and the aborted Maytas acquisition deal was*

*the last attempt to fill the fictitious assets with real ones"*¹¹. Raju stated that *"it was like riding a tiger, not knowing how to get off without being eaten"*¹²

- The auditors, bankers and Securities and Exchange Board of India were all blamed for their role in the accounting fraud at Satyam¹³. Bhasin listed the following factors that contributed to the fraud:
 - Greed
 - Ambitious corporate growth
 - Deceptive reporting practices and lack of transparency
 - Excessive interest in maintaining stock prices
 - Executive incentives
 - Stock market expectations
 - Nature of accounting roles
 - High risk deals that went sour
 - Internal and external audit failures
 - Aggressiveness of investment and commercial banks, rating agencies and investors
 - Weak independent directors and audit committee
 - Ineffective whistleblower policy

⁹ KPMG – Global profiles of the fraudster

¹⁰ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

¹¹ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

¹² Basilico et al – Asia's Enron: Satyam (Sanskrit word for truth)

¹³ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

- Hamilton and Micklethwait categorised the main causes of corporate failures as follows¹⁴:
 - Poor strategic decisions
 - Overexpansion and misguided acquisitions
 - Dominant CEOs
 - Greed, arrogance, pride and the desire for power
 - Failure of internal controls at all levels
 - Incompetent or ineffective boards

This publication further categorises some of the common themes observed in the case studies and discusses each in further detail. The main theme that was observed throughout the research is that a variety of role players, factors and circumstances culminated into these corporate disasters.

The following summarises the main themes observed in the case studies and is discussed in further detail in this publication:

- Auditors have been criticised, investigated, and taken to court and many articles written in attempts to understand the role that auditors played or didn't play and whether they should have known that

fraud was occurring within the organisation. The independence and relationships between clients and auditors have come under scrutiny. The quality of audit work performed was considered to be of less than desirable standard where corporate failures occurred. Finally, consideration is also given to the expectation that auditors should identify fraud and whether that expectation is realistic

- Corporate governance was also touted in many instances as the main reason for corporate failures. Attempts at curbing these failures in the form of more stringent legislation and regulation does not appear to have had the desired impact. The reasons why corporate governance failures cannot be regarded as the sole contributing factor to corporate failures is also discussed in more detail
- The pressure cooker syndrome considers the internal and external pressures that the leaders of corporate failures endured, putting some of the responsibility at the door of each stakeholder, banking institution, analyst and the public that missed the red flags
- Leaders in organisations experiencing corporate failures have been sentenced to jail, paid

substantial fines and walked away with reputations a little less intact. We consider the character traits highlighted by numerous authors to understand the leaders of failed corporates. However, one transparent fact cannot be ignored and is observed across all case studies, ie a blatant belief in their own power and their ability to create magic and their deliberate actions to execute such belief

Auditors: the role they played/didn't play

As mentioned earlier, the specific role of the auditors in every corporate failure has come under scrutiny. It seems, however, that no clear answer emerges but rather that a combination of events, circumstances and even mishaps culminated into the auditors' role, integrity and professionalism being questioned.

Consideration is given below to the auditor's role in our specific case studies as well as a few examples of actual management frauds investigated, demonstrating how auditors may be at the mercy of deliberate actions by management to deceive and disguise the truth.

¹⁴ Hamilton and Micklethwait – Greed and corporate failure

To be or not to be independent

The auditors' independent opinion provides credibility to financial statements¹⁵. Mirshekary et al highlighted, amongst others, the following independence issues regarding the HIH auditors:

- The auditors paid consultancy fees to the HIH chairman over a period of nine years, which included the use of an office and secretary at the audit firm. This relationship with the chairman was not disclosed to the board. The independence of the chairman was also questioned as a result of his relationship with the auditors
- During 1997, HIH appointed a previous audit partner as COO immediately after he resigned from the audit firm. This COO also supervised the two auditors performing the audit of HIH during 2000
- During the 1999/2000 financial year, the audit firm also received consulting fees amounting to A\$1.6 million from HIH while the audit fee for the same period was A\$1.7 million

HIH was regarded as a high-risk audit client due to past difficulties in resolving disputes with management, however, no risk management plan was prepared for HIH as an audit client¹⁶.

The auditors of Enron also showed lack of independence and received fees for auditing as well as consulting services¹⁷. The auditors were also said to have engaged in regular exchanges with Enron employees.

Specific risk areas were identified by the auditors related to the relationship of Adelphia with the Rigas family and the 72 family businesses¹⁸. Adelphia was one of the audit firm's largest and most long standing clients in a particular office of the audit firm and it was speculated whether long-term relationships could have developed and impacted the independence of the auditors.

The concerns over auditor independence and close personal relationships with client staff will always remain. Although regulation and audit standards have been bolstered, the possible influence that individuals exercise over each other will always be difficult to prove and manage effectively. The management of such relationships may also depend on certain character traits of the particular individuals involved as some leaders have used their powers to influence certain behaviours and hence impacting the quality of audit work performed.

The drivers of quality audits: money and trust

Consideration is given to the key drivers of a quality audit, ie:

- Audit fees, which can impact the quality and level of audit procedures performed
- Trust, which is a necessary element of any relationship, but has been intentionally exploited by many managers to influence people around them

Audit fees compromised

HIH was unwilling to increase the audit fees, which led the auditors to reducing their procedures on the audit¹⁹.

Antar admits to employing various tactics to ensure that the auditors could not complete the required field work properly or in time²⁰. He indicated that the auditors "... *would have to skimp on certain key procedures. This plan worked every year*" and "... *chumminess also helped us become more likable to our auditors and corrode their professional scepticism. They did not want to believe we were crooks. They believed whatever we told them without verifying the truth. You can steal more with a smile!*"

¹⁵ Mirshekary et al – Australian corporate collapse: the case of HIH Insurance

¹⁶ Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹⁷ Khan – The reasons behind a corporate collapse

¹⁸ Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹⁹ Mirshekary et al – Australian corporate collapse: the case of HIH Insurance

²⁰ Antar – White collar fraud

Trust abused

Antar boasts, and even appears quite proud, of how auditors were pressured and their trust abused in the Crazy Eddie saga²¹. Similar deliberate misrepresentations by management were observed in the case studies of Satyam, Adelphia and HIH.

As Crazy Eddie reduced the skimming of cash sales, the company could no longer pay the employees in cash or “off the books”. Employees’ salaries were grossed up to keep their net income the same because it would be subjected to payroll taxes. The employees’ salaries therefore increased excessively. Antar boasted that “... *the gullible auditors accepted our silly explanation that our employees had sacrificed many years working below average wages for the opportunity to be part of what they hoped might become a growing public company*”.

Antar described further frauds committed by overstating revenue and understating accounts payable. One example, was the influence that Antar had over a supplier, which he convinced to deliver inventory of \$3 million to \$4 million but not to invoice before the audit was completed. Antar again indicated that the “*lax audit procedures facilitated our crimes*”, as auditors relied on Crazy Eddie employees counting

stock and providing the auditors with the inventory numbers.

Crazy Eddie also created fictitious debit memos for claims to be paid by suppliers and changed their accounting policy from “*Purchase discounts and trade allowances are recognised when received*” to “*Purchase discounts and trade allowances are recognised when earned*”. According to Antar, the volume of debit memos resulted in some supplier balances showing money owed to Crazy Eddie but the auditors failed to recognise these red flags and did not perform any work to confirm the validity of the debit memos.

At Satyam, Raju indicated that he created 6 000 fictitious salary accounts and took the money²². The company’s global head of internal audit was also part of the accounting fraud, as he created fake suppliers and fictitious invoices to increase revenue, falsified board resolutions and illegally obtained loans for the company.

Adelphia’s auditors suspended their work for the financial year ending December 2001, as they would not rely on the information provided by management and required an extension on the scope of the audit²³. The auditors apparently claimed that Adelphia’s senior management misled the auditors, withheld information and created fictitious documents.

Concerns were raised regarding the evidence used by the auditors to ascertain if HIH could continue as a going concern²⁴. The auditors asserted that HIH was a going concern in the audit report of June 2000, only nine months before HIH failed. It transpired that the auditors were aware of certain inaccuracies in HIH’s budgets and forecasts but continued to use the same working papers to verify management’s assertion of a going concern. Furthermore, the auditors accepted management’s intention to sell a portion of the business to generate A\$200 million cash flow. However, this sale only occurred later in 2000. Further concerns were raised as to whether the auditors compiled working papers at all, as the original documents for classifying HIH as a going concern could not be located.

It is evident that auditors were intentionally misled, manipulated into performing lesser quality audit work and simply accepted explanations provided by management without further verification. This by no means excuses the behaviour of the auditors in not managing the relationship with the client or missing red flags.

²¹ Antar – White collar fraud

²² Bhasin – Corporate accounting scandal at Satyam: A case study of India’s Enron

²³ Van Peursesem et al – Three cases of corporate fraud: an audit perspective

²⁴ Mirshekary et al – Australian corporate collapse: the case of HIH Insurance

The conundrum is however whether auditors can be expected to identify fraud committed by management in view of management's intentional influence and misrepresentations.

The expectation gap

Although Antar pointed out influence over the auditors, pressure to complete audit work and lack of diligence by the auditors in following up red flags, he acknowledged that no amount of audit procedures will make up for lack of internal controls²⁵.

Bhasin stated that *"a financial audit simply cannot be relied upon to detect fraud at any significant level"*, as audits are not designed or executed to detect frauds²⁶. Bhasin further stated that audits would only detect approximately 10% of frauds. The Association of Certified Fraud Examiners maintains that audits are ineffective although it is the most widely used mechanism to detect fraud and prevent losses²⁷. Du Toit also stated that auditors cannot provide absolute assurance that all material misstatements are detected and identified and that ethical behaviour is essential²⁸.

A recent survey of 750 investigations conducted by KPMG world-wide further supports the above and revealed that external auditors were responsible for identifying fraud only in 6% of the cases surveyed. Considering that management and executives were involved in fraud in 68% of cases surveyed, it is evident that audit procedures may not always lead to the detection of fraud due to the involvement of seniors. The most common method of detecting fraud still remains anonymous tip-offs or reporting via a whistle blower mechanism in 35% of cases surveyed.

The spotlight turned to the auditing profession following a number of international fraud scandals²⁹. For example, at California Micro Devices auditors were charged with *"improper professional misconduct relating to the audit"* where fraud by top management was discovered. The auditors were charged for failing to exercise proper professional scepticism and ignoring red flags that indicated possible irregularities. Such events cause damage to the credibility of the auditor³⁰.

Other red flags to fraud at management levels include disputes among top management, overriding dominance of the chairperson or CEO or even lack of debate of business issues at board level. This raises the question whether the auditor alone is able to successfully expose inconsistencies between responses received from management and those charged with governance as required by ISA 240 – *"The auditor's responsibilities relating to fraud in the audit of financial statements"*³¹.

In response to the above, the profession implemented ISA 200 – *"Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing"*. The procedures for the registered auditor to respond to the risk of fraud during the audit of financial statements were set out in ISA 240³².

Auditors do not have the necessary experience and knowledge on how to detect fraud, as they did not receive training on the subject³³.

²⁵ Antar – White collar fraud

²⁶ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

²⁷ McCartney – Where there's smoke, there's fraud

²⁸ Du Toit – Characteristics of companies with a higher risk of financial statement fraud: A survey of the literature

²⁹ Jackson and Stent – Auditing notes

³⁰ Christensen et al – Will you need a forensic accountant?

³¹ The South African Institute of Chartered Accountants – SAICA electronic handbook

³² Jackson and Stent – Auditing notes

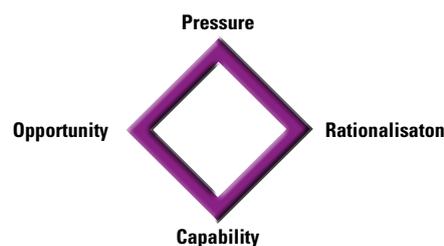
³³ Christensen et al – Will you need a forensic accountant?

The auditing profession formally adopted a framework, referred to as the fraud triangle, to understand and manage fraud risks³⁴. This framework refers to the pressure to commit fraud, the opportunity to do so and a rationalisation of the act.

Du Toit refers to the updated fraud triangle by Kassem and Higson, who indicated that researchers interpret the motivation/pressure portion of the triangle differently³⁵. In order to better define motivation, Kassem and Higson expanded the triangle to include MICE representing the motivators used by perpetrators to justify their inappropriate actions. MICE represents money, ideology, coercion and ego. They also added a fourth element to the fraud triangle, representing the fraudster's capabilities to commit a crime.



Wolfe and Hermanson added a fourth element creating a fraud diamond³⁶. This fourth element is the individual's attributes or capability to observe the three elements in the fraud triangle and then applying those capabilities to commit the fraud.



Wolfe and Hermanson described people who have the capability to commit fraud as follows³⁷:

- The person's position may present the capability to take advantage of an opportunity to perpetrate fraud. CEOs perpetrate more than 70% of public company accounting frauds highlighting that companies did not implement adequate measures to mitigate the CEOs capabilities to influence others and commit fraud
- In at least 51 % of frauds, people who commit the fraud have an in-depth understanding and knowledge of system and control weaknesses and are professionally qualified. Further, managers and executives commit fraud in 46% of cases

- Such people strive to succeed at all costs
- They also have the skill to convince others to perpetrate or conceal fraud and sometimes achieve this by instilling fear upon their subordinates
- These fraudsters lie effectively and constantly and deal very well with pressure

A recent survey of 750 investigations conducted by KPMG world-wide revealed that management and executives were involved in fraud in 68% of cases.

In assessing fraud risks, the auditor therefore also has to consider this fourth element of fraud, ie capability. Later in this publication, the ethics and characteristics displayed by those leaders that committed fraud is discussed in further detail.

Assessing an individual's propensity to commit fraud may require experience in interviewing people, and in particular management and executives, as well as observing their specific behaviour and attitude towards business. This is where the use of a forensic accountant becomes fundamental. However, there are still debates surrounding the use of forensic accountants versus non-forensic accountants to assess fraud risks.

³⁴ Wolfe and Hermanson – The fraud diamond: Considering the four elements of fraud

³⁵ Du Toit – Using financial analysis and interpretation as a foundation to comprehend financial health

³⁶ Wolfe and Hermanson – The fraud diamond: Considering the four elements of fraud

³⁷ Wolfe and Hermanson – The fraud diamond: Considering the four elements of fraud

The use of forensic or non-forensic accountants

The American Institute of Certified Public Accountants indicated that auditors should increase forensic procedures to detect fraudulent financial reporting³⁸. Fraudulent financial reporting had more than doubled since 1998³⁹. Management and executives usually commit fraudulent financial reporting and the specific skills and experience of a forensic accountant may be able to highlight areas for an auditor to expand testing and audit procedures in order to reduce the risk of not detecting such fraud.

A recent survey of 750 investigations conducted by KPMG world-wide further supports the above and revealed that fraudulent financial reporting occurred in 22% of cases surveyed.

The call for more forensic procedures in an audit sparked a debate over the use of forensic accountants during financial statement audits.

The Sarbanes Oxley Act of 2002 also places additional pressure on auditors to detect fraud and material misstatement during the audit of financial statements. Christensen et al suggests that companies should require forensic accountants to be included on the audit team, as this would provide

greater assurance with regard to the requirements for detecting fraud⁴⁰.

The use of forensic accountants can therefore be a major advantage to both management and the auditor in detecting fraud⁴¹. Bhasin also indicated that more reliance is placed on specific forensic skills to identify poor corporate governance, weak internal controls and fraudulent financial reporting⁴².

Charles R Drott, a member of the California Board of Accountancy, a CPA and fraud examiner, stated that *"If GAAS as they exist today were complied with – with a sceptical mind and the exercise of due care – forensic specialists to a significant degree would not need to be called on to detect fraud"*. He is of the opinion that auditors and forensic accountants do not have different mind-sets and believes that audit failures occur because of a lack of scepticism exercised by auditors⁴³.

As described above, the debate centred on the following two fundamental issues, which created an expectation gap:

- More forensic accounting procedures, and therefore forensic specialists, should be included in the audit teams
- Auditors already have these investigative responsibilities and skills under generally accepted auditing standards

A number of clients were shocked to discover frauds perpetrated by senior management members. Naturally, their question was why the auditors did not detect the fraud. Upon analysis of the information and deeper investigation into transactions, certain red flags were present. However, should management have presented documentary evidence and reasonable explanations, the auditor can be expected to accept such.

This provides the forensic accountant with an opportunity to start addressing the expectation gap by highlighting the role of an auditor and the purpose of a financial statement audit and describing the difference between an auditor and forensic accountant.



³⁸ IOMA (Institute of Management & Administration Inc) – AICPA wants more forensics in financial reporting audits

³⁹ Wolfe and Hermanson – The fraud diamond: Considering the four elements of fraud

⁴⁰ Christensen et al – Will you need a forensic accountant?

⁴¹ Christensen et al – Will you need a forensic accountant?

⁴² Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

⁴³ IOMA (Institute of Management & Administration Inc) – AICPA wants more forensics in financial reporting audits

A new approach to audit is required as fraud continues to grow⁴⁴. Lekan even goes as far as naming the expert who can detect and expose fraud a “*frauditor*”. The table below summarises the differences between an auditor and a “*frauditor*” as described by Lekan.

- Solnik stated that knowing how to read a balance sheet is only one tenth of what a forensic accountant does⁴⁶. He further indicated that forensic accountants are financial experts and “... *students of human nature as well as numbers*”

their financial performance results subsequent to the acquisition, management reports were manipulated. Certain ratios revealed that there was no correlation between the sales, cost of sales and increasing inventory levels but the holding company and auditors did

Auditor	“Frauditor”
Evaluates information based on the premise that it may be flawed but not corrupt	Treats everything with suspicion
Thinks that people are honest	Is always sceptical
Asks Yes/No questions	Conducts interviews and asks open-ended questions
Relies on direction	Observes non-verbal clues
Views a lack of control as an opportunity to improve	Views a lack of control as a possibility for further investigation
Is all about the business	Is all about wrongdoing
Reviews and asks questions based on documentation	Authenticates documentation
Checks numbers against good practice	Views numbers as false to begin with

In conclusion, Lekan indicated that training was essential to transform from an auditor to a “*frauditor*”.

Auditors use forensic accountants progressively more to assist with the detecting of fraud during audits as indicated by the following examples:

- Wells describes how a certified fraud examiner was able to uncover a fraud, perpetrated by the CEOs, after an auditor reported certain variances to him⁴⁵

- Orenstein indicates that more companies are proactively using forensic audit services to provide a “*fresh look*” in addition to their auditor⁴⁷
- Although a client had a due diligence performed before acquiring another company, fraud was only discovered years later. During a forensic investigation it was determined that the management of the newly acquired subsidiary had started manipulating their financial results six months prior to the anticipated acquisition. In order to maintain

not identify these inconsistencies due to various explanations and delay tactics by management

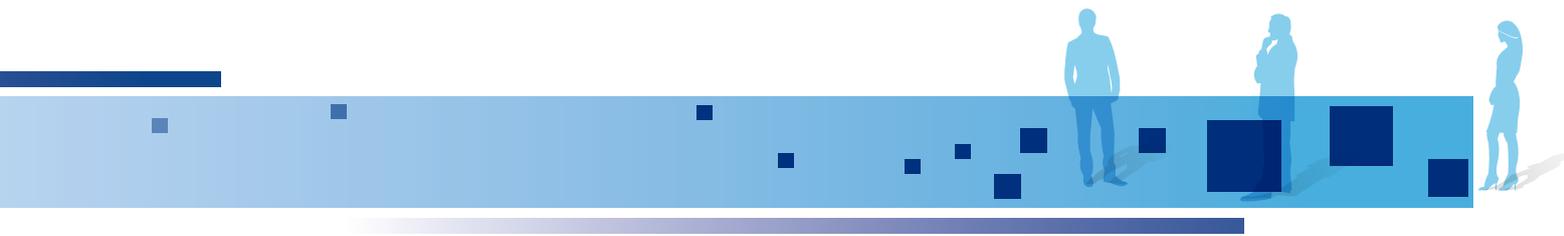
- Following high-level introductory training on procurement frauds to a group of first year auditors, one auditor re-performed certain procedures and identified fraud, simply because the frame of mind was broadened with alternative options
- Various queries have been referred to forensic investigators for consideration from internal audit departments. After further

⁴⁴ Lekan – Making an auditor a “*frauditor*”

⁴⁵ Wells – The quarter-million-dollar caper

⁴⁶ Solnik – The big sweep

⁴⁷ Orenstein – Ask FERF about... forensic audit services



investigation and seeking corroboratory evidence, frauds were uncovered. In these cases, the internal auditors recognised the red flags but needed further assistance to gather the appropriate evidence to further the matter

It is therefore clear that forensic accountants have a role to play during audits. The question that remains is to what extent.

Bridging the expectation gap is therefore a process of creating awareness among investors and shareholders of the scope of the financial statement audit and the value it provides as well as what it cannot provide⁴⁸. Auditors are not required to analyse all non-financial data of a company, some of which could indicate fraud risks.

The expectation gap between auditors and forensic accountants can be further decreased with an understanding of the role a forensic accountant could fulfil during the audit of financial statements and/or providing training to auditors on specific fraud risk areas identified by the auditors to enable the auditors

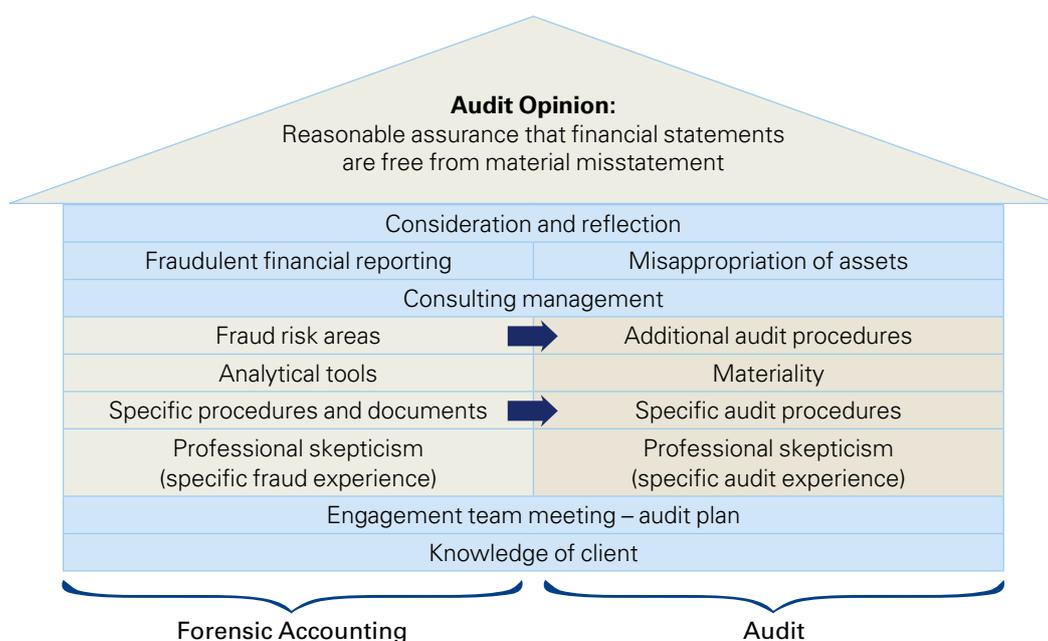
to know when additional help can be obtained from forensic accountants as depicted in the diagram below.

The auditor shares the specific knowledge of the client with the forensic accountant at the beginning of the audit. The engagement team, including the forensic accountant, should sit together to compile the audit plan.

The auditor and forensic accountant each apply professional scepticism within their particular field of expertise to design audit procedures. During this design phase, the forensic accountant can recommend specific procedures

to perform and particular documents to obtain during the audit.

During the assessment of the results of these audit procedures and the review of documentation obtained by the audit team, the forensic accountant will consider the specific fraud risk areas and will discuss these with the audit team to compile and perform additional audit procedures. Examples of areas where the forensic accountant should be included to assess fraud risk are revenue and unusual transactions.



⁴⁸ KPMG – The way forward: Changing what we audit

ISA 240 provides examples of management override of controls, which may lead to fraudulent financial reporting and indicates that individuals with specialised skills and knowledge be assigned tasks on the audit team to assist with assessing the identified risks of material misstatement due to fraud⁴⁹. Such specialists may include forensic and technology experts. ISA 240 also requires auditors to assess journal entries and adjustments⁵⁰. Forensic accountants with access to specific technology expertise and analysis tools could greatly assist the audit team with analysis of journal entries and adjustments.

The forensic accountant should further be involved during consultation with management. The audit team and forensic accountant then discuss accounting estimates and replies given by management and consider any identified fraud risk areas.

Finally, the forensic accountant may provide the auditor with recommendations regarding improvements where fraud risks exist.

Not only have auditors been in the firing line following corporate failures, CEOs and boards have also been called to task on the execution of their duties and why fraud occurred under their management and oversight.

No governance over fraud

The case studies revealed numerous governance issues, including *inter alia* the following:

- Non-independent board and audit committee members, for example where a CEO fulfilled multiple roles in various committees
- Inadequate governance structures, for example, lack of board committees or committees consisting of a single member
- Inappropriately qualified members, for example, family members holding board positions or audit committee members not having appropriate accounting and financial qualifications or experience to analyse key business transactions
- Ignorance by auditors, regulators, analysts etc of the financial results and red flags
- Management, who deliberately undermine the role of the various governance structures through the circumventing of internal controls and making misrepresentations to auditors and the board

The lack of corporate governance or poor corporate governance was observed in the following instances:

- Adelpia
 - John Rigas was the CEO and chairman of the Adelpia board⁵¹. His three sons were all directors and held senior management positions. His son-in-law was also a board member
- HIH
 - Sydney-based Corporate Governance International gave HIH a zero out of five rating for corporate governance in the four years prior to its collapse⁵². It was further stated however that the financial institutions that used the services of Corporate Governance International did not pay attention to the ratings
 - The auditors, government regulator, board and even the media were said to have known about the impending collapse of HIH⁵³
 - The board consisted of three former audit partners, one of whom was the chairman of the board who also received consultancy fees from HIH⁵⁴

⁴⁹ The South African Institute of Chartered Accountants – SAICA electronic handbook

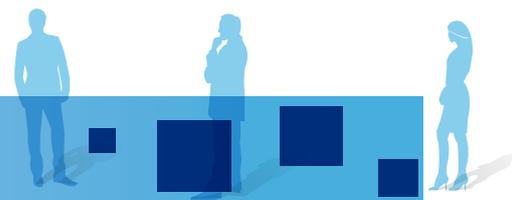
⁵⁰ The South African Institute of Chartered Accountants – SAICA electronic handbook

⁵¹ Van Peurse et al – Three cases of corporate fraud: an audit perspective

⁵² Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"

⁵³ Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"

⁵⁴ Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"



- Williams dominated the company and included friends and associates on the board, creating a lack of accountability and independence within the board⁵⁵
- Audit committees are an integral part of corporate governance and includes responsibilities to oversee the management reporting process and communication with external auditors⁵⁶. The chairman of HIH was also the chairman of the audit committee
- WorldCom
 - WorldCom’s board, internal audit and external auditors were clearly ineffective⁵⁷
 - One analyst in particular, touted WorldCom stock and sat on the board⁵⁸
- Satyam
 - Basilico et al identified numerous non-financial red flags associated with corporate governance failures at Satyam, including the following⁵⁹:
 - The presence of a powerful CEO, specifically when the CEO is also the chairman of the board, which results in a lack of independence between the CEO and chairman
 - Lack of independent directors. Multiple board members were linked to the Harvard University as well as the Indian government. Raju had also been involved with the Indian government since 1995 on a continued basis. Raju’s wife was also a member of the Satyam board and more than ten Indian firms
 - The audit committee consisted of members lacking the necessary accounting and financial expertise to perform their roles effectively
 - Use of the CEO’s dominant position, together with family members, to benefit themselves instead of shareholders. The family members diverted cash reserves as investments in sister companies since the beginning and shareholders questioned these practices during 1991, 1992 and 2008 when the proposed investment in the two Maytas companies were halted
- Enron
 - Enron’s board was paid twice the national average and had knowledge of certain special purpose entities, high risk accounting practices, off-the-book transactions, and inappropriate transactions due to conflicts of interest⁶⁰. Khan stated that the directors therefore had a shared responsibility in the failure of Enron



⁵⁵ Mak et al – Australia’s major corporate collapse: Health International Holdings (HIH) Insurance “May the force be with you”

⁵⁶ Mirshekary et al – Australian corporate collapse: the case of HIH Insurance

⁵⁷ Hamilton and Micklethwait – Greed and corporate failure

⁵⁸ Hamilton and Micklethwait – Greed and corporate failure

⁵⁹ Basilico et al – Asia’s Enron: Satyam (Sanskrit word for truth)

⁶⁰ Khan – The reasons behind a corporate collapse

The world's reaction to poor corporate governance was to increase governance through legislation and regulations but this does not appear to have had the desired effect.

More regulation, less governance?

Du Toit stated that *"Governments and professional organisations around the world have started to devise and implement laws and guidelines with the goal of preventing accounting irregularities from occurring"*⁶¹. These measures include, amongst others, the Sarbanes-Oxley Act from America, the Turnbull Guide on corporate governance from the United Kingdom and the King Report in South Africa. However, these may not be as effective as need be.

The Committee of Sponsoring Organisations of the Treadway Commission's report indicated that corporate fraud continues to increase despite Sarbanes-Oxley⁶². It was stated that the methods of committing corporate fraud have not changed much and that the traditional corporate governance measures have little impact on predicting fraud. Mak et al also indicated that the HIH Royal Commission report revealed that little has changed to prevent unexpected corporate failures⁶³.

KPMG's Global profiles of the fraudster survey revealed that 50% of cases

investigated occurred in countries with highly regulated environments, ie the US and China⁶⁴.

It therefore appears that more regulation has not resulted in more effective governance over corporates.

Implementing the regulatory and best practice guidelines for good corporate governance has been a costly and cumbersome exercise for most companies. The implementation of *"better"* governance structures has become a checklist exercise to ensure compliance.

The major risk still being observed during various forensic investigations indicate that the mind-sets of management and those tasked with governance have not really changed. Some members of governance structures are not aware of the onerous positions that they hold and the full extent of the responsibility and accountability ascribed to them.

Consideration is given later in this publication to the specific character traits that have been observed in corporate failures, which could provide insight into why more legislation and regulation has not reduced the occurrence of management fraud.

Next, we explore a further factor that contributed to corporate fraud, ie the

perceived pressure by management to achieve positive results or conceal financial difficulties.

The pressure cooker syndrome

An entirely separate publication could probably be dedicated to society's definition of success and its intolerance of failure or poor performance, however, this publication is merely seeking to identify those factors that led to corporate failures. Due to the economic pressures and expectations to meet tough targets, companies therefore experience or perceive pressure to achieve the desired results. When such results are not realised, more companies resort to financial statement fraud and manipulation of earnings to demonstrate growth instead of admitting the reality.

Kaptein indicated that goals are essential and have a positive effect on people's effort, persistence and achievements⁶⁵. However, the hidden danger in striving for a goal is tunnel vision, which Kaptein indicated also occurs in organisations. Kaptein further stated that *"When particular goals dominate, unscrupulous behaviour may go unnoticed: the end justified the means. We see tunnel vision in the organisation that must grow at any cost"*

⁶¹ Du Toit – Using financial analysis and interpretation as a foundation to comprehend financial health

⁶² McCartney – Where there's smoke, there's fraud

⁶³ Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"

⁶⁴ KPMG – Global profiles of the fraudster

⁶⁵ Kaptein – Why good people sometimes do bad things

and makes everything subordinate to that goal..."

CEOs and CFOs commit accounting fraud to conceal poor financial performance, preserve their personal status and control and to maintain their personal income through performance-based bonuses⁶⁶.

The committing of fraud is intended to benefit the organisation, for example overstating profits, but may benefit management through bonuses based on profitability⁶⁷.

Antar's description below of how management deliberately committed fraud to achieve the results expected by the public, provides insight into the pressure cooker syndrome and seemingly desperate actions taken to not admit failure by reporting poor financial results as well as maintaining their own financial position⁶⁸.

During 1986, Crazy Eddie became concerned that it would not achieve analysts' projections. The company needed to raise about \$35 million in new capital. Eddie Antar and Sam M Antar (Eddie's father and Antar's uncle) also wanted to sell their shares worth \$20 million at the time. The difference between analysts' projected sales growth of 10% and the actual 4%

increase in sales was approximately \$2.2 million. The "Panama Pump" scheme was implemented to make up the \$2.2 million sales required. This involved the withdrawal of funds from secret family bank accounts in Israel and transferring it to Crazy Eddie's bank accounts. These funds were reported as sales. According to Antar, auditors performed insufficient procedures to confirm the sales against invoices and did not confirm the actual sources of the funds. Antar also indicated that the auditors missed other red flags such as the time when the funds were deposited, ie the Monday following the end of the financial year. It therefore appeared that Crazy Eddie had a 90% increase in sales during the last two days of the financial year. The market liked the financial results and further shares were sold, raising \$39 million in new capital, Eddie Antar and his father, Sam M Antar, also sold their shares and received \$24 million in proceeds.

The following examples from the case studies also demonstrate internal and external pressures perceived or experienced by management and ultimately motivating them to commit fraud to report expected results and maintain their own financial position:

- Basilico et al described Raju's management style as one of seeking double-digit revenue growth at Satyam⁶⁹. During January 2009, Raju

indicated that he overstated assets by \$1.47 billion⁷⁰. Almost \$1 billion of bank loans and cash reflected on the balance sheet was fake, as Raju fabricated bank statements on his personal computer. Liabilities were also understated. Satyam overstated income over a period of several years to meet analysts' expectations, including interest ostensibly earned from the fake bank accounts

- Enron's management was expected by shareholders to live up to unreasonable expectations⁷¹. Khan also stated that Enron's investment banks, attorneys, accountants and auditors had knowledge and were allegedly involved in certain transactions. Enron's management also received stock options, which may explain their focus to drive rapid growth and inflate earnings
- Ebbers approved excessive bonuses to key employees, including Sullivan and himself. The accounting fraud was not the reason for the demise of WorldCom. Ebbers's shopping spree in acquiring other entities was based on poor strategic decisions and excessive prices paid for acquired entities, increasing WorldCom's debt burden⁷²
- Mak et al cited the findings of the HIH Royal Commission report,

⁶⁶ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

⁶⁷ Bologna and Lindquist – Fraud auditing and forensic accounting: New tools and techniques

⁶⁸ Antar – White collar fraud

⁶⁹ Basilico et al – Asia's Enron: Satyam (Sanskrit word for truth)

⁷⁰ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

⁷¹ Khan – The reasons behind a corporate collapse

⁷² Hamilton and Micklethwait – Greed and corporate failure

which indicated that Williams, the CEO, and his allies were responsible for the failure of the company due to gross mismanagement, charging too little for premiums and not providing for enough funds to pay out claims⁷³. Apparently, insurance analysts and others warned the management, directors, auditors, actuaries, various insurance brokers as well as the government regulator (APRA) that the company was being endangered by under-providing for future claims 18 months before the demise of HIH

- Management's expansion plans for LeisureNet was *"hopelessly aggressive"*. Management started recognising the probable future income from Health and Racquet Club subscriptions early in order to fund the expansion⁷⁴

KPMG's global profiles of the fraudster survey indicated that fraudsters worked for victim organisations for more than six years and nearly three quarters of frauds were committed over a one to five year period⁷⁵. *"This implies that fraudsters do not join an organisation with the aim of committing fraud. But changes in personal circumstances or pressures to meet aggressive business targets may create the conditions conducive to fraud"*.

Why would these pressures drive someone to commit fraud? The answer may lie in particular characteristics that, if the correct circumstances presented itself, would trigger the capability of a person to act thereon.

The capability to commit fraud

As described earlier, various adjustments have been made to the traditional fraud triangle to incorporate the capability of individuals to commit fraud. KPMG's global profiles of the fraudster survey included the capability of the person who commits fraud as a component of opportunity in the fraud triangle⁷⁶. Capability describes the attributes or personal traits of the fraudster that enables him/her to exploit the opportunity when it arises. A number of the previous themes discussed in this publication also specifically indicate intentional manipulation of events or people in order to commit fraud.

Following is a number of examples of people, and more specifically management and executives, possessing and who, in some instances, utilised their capability to commit fraud:

- The internal auditor at WorldCom explained how management could attempt and may even succeed to mislead auditors. The CFO used his position and seniority to dissuade the internal audit team from looking into certain areas later found to be fraught with fraud⁷⁷
- Executives of California Micro Devices forged reports to mislead auditors, bankers and the board of directors. The auditors were charged with *"improper professional conduct relating to the audit"*⁷⁸

KPMG's global profiles of the fraudster survey quoted Nigel Layton, Partner, Head of Forensic, Risk Consulting for KPMG in Russia and the CIS *"We do not see one personality profile that commits fraud; all types of people commit fraud if the opportunity presents itself"*⁷⁹.

⁷³ Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"

⁷⁴ Editorial Comment – Leisure netted

⁷⁵ KPMG – Global profiles of the fraudster

⁷⁶ KPMG – Global profiles of the fraudster

⁷⁷ Wolfe and Hermanson – The fraud diamond: Considering the four elements of fraud

⁷⁸ Christensen et al – Will you need a forensic accountant?

⁷⁹ KPMG – Global profiles of the fraudster

Bhasin stated that fraud is perpetrated by *“groups of unscrupulous individuals [that] manipulate, or influence the activities ... with the intention of making money or obtaining goods through illegal and unfair means”*⁸⁰.

Therefore, while fraudsters identify an opportunity and have the inclination to pursue that opportunity, they rationalise their behaviour, thereby convincing themselves that they are not doing anything wrong.

Kaptein referred to various rationalisations identified by researchers (see table below)⁸¹.

Having insight in the above rationalisations provides an indication of the individuals capable of intentionally committing fraud.

Kaptein also described the halo effect as a generalisation of apparent goodness by an organisation and person to view the entire organisation or person as good⁸². He indicated that organisations and individuals could use this on purpose or subconsciously to steer others in the wrong direction.

The deliberate actions by management-level fraudsters are discussed in further detail with reference to the circumventing and taking advantage of weaknesses in internal controls, the perceived rewards to be obtained by the individuals taking the risk to commit fraud, the ethical and moral considerations of perpetrators of fraud and the deliberate actions to achieve the impossible.

In conclusion, reference is made to the characteristics displayed by leaders of failed corporations.

Circumventing internal controls

KPMG’s global profiles of the fraudster survey quoted Niamh Lambe, Director of KPMG, Head of KPMG Forensic Ireland *“Having good internal controls is important, but with any control you are ultimately relying on the human element”*⁸³.

The following statistics in KPMG’s global profiles of the fraudster survey support the view that fraud involved the deliberate overriding of internal controls⁸⁴:

- 54% of frauds were facilitated by weak internal controls
- Strong internal controls will not prevent all fraud

Rationalisation	Examples
Denying one’s own responsibility	It’s not my fault
Denying disadvantage to another party	No one will suffer for this What they don’t know won’t hurt them
Denying a victim	They asked for it You get what you deserve
Condemning those who condemn the misdemeanour	They should take a look at themselves He started it
Blaming their action on loyalty to another	I didn’t do it for myself
An image of balance is raised	On balance I’ve done more good than bad
People point to others	Everyone does it
Negative intentions are denied	It was only a joke
People call on relative acceptability	Others are worse than me

⁸⁰ Bhasin – Corporate accounting scandal at Satyam: A case study of India’s Enron

⁸¹ Kaptein – Why good people sometimes do bad things

⁸² Kaptein – Why good people sometimes do bad things

⁸³ KPMG – Global profiles of the fraudster

⁸⁴ KPMG – Global profiles of the fraudster

- 20% of frauds were committed regardless of the controls
- 11% of fraudsters colluded with others to circumvent internal controls

A recent survey of 750 investigations conducted by KPMG world-wide further supports the above and revealed that weak internal controls were identified in 60% of cases surveyed. In 21% of cases surveyed, dishonesty was identified regardless internal controls. Management circumvented internal controls in 27% of cases surveyed. Collaboration to override internal controls occurred in 11% of cases surveyed.

Although the primary responsibility of management is to prevent and detect financial statement fraud, they are often the perpetrators of such fraud⁸⁵.

Fraudsters, by virtue of their tenure and seniority at the organisation, understand internal controls and how to circumvent them or find flaws in the internal controls and exploit them. The specific character traits exhibited by fraudsters also indicate that morals and integrity do not play a role as described in more detail later in this publication.

Such fraudsters therefore have no qualms about overriding internal controls or expecting/convincing

others to do so. It therefore begs the question why management-level frauds occur. Although a number of themes have been identified that create the opportunity to commit fraud, such as poor audits or inadequate corporate governance as well as pressures from a variety of external sources to show growth and positive financial results, the natural person would expect some kind of reward to be associated with such serious acts.

Risk and reward

According to Kaptein, *“Wrong can sometimes be very attractive”*⁸⁶.

Does this mean that fraud is not committed for any form of reward regardless of the risks associated with being convicted? It seems that several rewards can be perceived by fraudsters as enough motivation to commit fraud. KPMG’s global profiles of the fraudster survey quotes Anne van Heerden, Partner and Head of Forensic for KPMG in Switzerland *“Typically, a person commits fraud to fund an extravagant, or at least very comfortable, lifestyle; we seldom see people turn fraudster to make ends meet. Already well off, we often wonder why they take the risk”*⁸⁷.

The above view of Anne van Heerden is supported by experience in numerous forensic investigations. The question is often asked why a particular person committed fraud, particularly

because the frauds were committed by management-level employees who were earning high salaries. As indicated earlier in this publication, a variety of rewards can be perceived by the fraudster as worth the risk, such as performance bonuses, achieving the expectations of shareholders, successfully hiding the true nature of the financial chaos, greed or simply the thrill of getting away with it and protecting their status.

Kaptein relayed the story of Abraham Lincoln (“Lincoln”), a respected lawyer at the time, who was approached by a criminal who admitted guilt and wanted Lincoln to defend him⁸⁸. Lincoln refused to defend the man but the man kept increasing the amount he was willing to pay for Lincoln’s services. Lincoln eventually threw the man out onto the street. When the man asked why Lincoln threw him out, Lincoln replied: *“You were nearing my price”*. The question is therefore how long and under what circumstances and what types of temptations honest people can resist and when they would relinquish their integrity.

The capability or likelihood that someone will commit fraud is not only driven by an opportunity presenting itself, the pressure to achieving possibly unrealistic results but their ability to rationalise their actions. While it is evident that motivation is largely based on greed, the rationalisation appears to

⁸⁵ Du Toit – Characteristics of companies with a higher risk of financial statement fraud: A survey of the literature

⁸⁶ Kaptein – Why good people sometimes do bad things

⁸⁷ KPMG – Global profiles of the fraudster

⁸⁸ Kaptein – Why good people sometimes do bad things

excuse the fraudsters of their actions by soothing their conscience into believing that they are not doing anything wrong.

Are these fraudsters therefore ethical or unethical? Do they not have any ethical compass at all?

The ethical conundrum

Ethics or lack thereof played a role in the various case studies. The management that perpetrated the frauds, as indicated earlier, believed they were creating magic. They became so comfortable, to the point of possibly being arrogant about what they were doing; they believed their own reasoning and did not stand for anyone disagreeing with them.

Based on the case studies, the ethical conundrum centres on the following three themes:

- Abuse of authority
 - Peterson stated that lack of integrity was a key characteristic impacting the development of an organisation's culture⁸⁹. He indicated that Skilling was a confident, intelligent and determined leader who was able to provide a vision for the company and his management style was to encourage creativity and risk-taking, particularly with reference to increased revenues. Employees

who spoke honestly were simply dismissed or demoted

- According to Kaptein, few people have the strength to resist authority⁹⁰. People's morals melt away under the pressure of authority
- This behaviour in itself creates further challenges, however, giving in to the authority of an unethical leader can never be an excuse for aiding fraud
- Believing in their own magic
 - Ebbers was quoted as saying the following to fellow church-goers *"I just want you to know you aren't going to church with a crook. No one will find me to have knowingly committed fraud."* Ebbers was later convicted of fraud and sentenced to 25 years in prison⁹¹
 - Kaptein described cognitive dissonance as the discomfort arising from a conflict between beliefs and behaviour⁹². To reduce the cognitive dissonance people seek new thoughts or ideas to adjust their current beliefs. Kaptein stated that: *"We want to see ourselves as rational and honest, so we think up reasons, often subconsciously,*

to reconcile the conflicting cognitions." According to Kaptein, the greater the cognitive dissonance, the greater the motivation to close the gap, which promotes moral blindness. He also stated that: *"Morals are sent on vacation and we continue to see ourselves as honest"*

- Ethics did not even come to mind
 - Antar stated that the family members never discussed the morality of the frauds⁹³. He indicated *"We never cared. In the early days when we were skimming the attitude was that the government was not entitled to tax our earnings... We always knew what we were doing was wrong."*
 - Antar was not afraid of getting caught while committing the frauds but rather that someone *"would ask good questions and seriously seek truthful answers from us"*⁹⁴. He also indicated that he *"did not cooperate with the government and civil plaintiffs for altruistic reasons. Fear of a very long prison sentence was my primary motivator. No sense of morality played a role in my decision to cooperate. It was purely a selfish decision motivated by fear."*

⁸⁹ Peterson – Enron case study

⁹⁰ Kaptein – Why good people sometimes do bad things

⁹¹ Kaptein – Why good people sometimes do bad things

⁹² Kaptein – Why good people sometimes do bad things

⁹³ Antar – White collar fraud

⁹⁴ Antar – White collar fraud

- Antar *“did a simple calculation and decided it was in my best personal interest to cooperate with the government than take my chances in trial. There was no moral awakening in that decision”*⁹⁵

The ethical conundrum cannot be successfully understood in a single publication, but does provide insight into the fraudster’s way of thinking.

In an attempt to understand the characteristics of fraudsters further, and in particular the leaders of failed corporates, the work of Finkelstein was considered⁹⁶.

A recent survey of 750 investigations conducted by KPMG world-wide further supports the above and revealed that fraudsters only self-reported or admitted to the fraud in 3% of cases surveyed.

Leaders of failed corporates

Finkelstein compared the effects of people who orchestrated corporate failures to that of earthquakes and hurricanes⁹⁷. He indicated that such *“spectacularly unsuccessful [people] requires some very special personal qualities”*. He acknowledged that these people are intelligent and have remarkable talent, are capable of being charming and inspiring others. Finkelstein further stated that the habits most admired in business, are the same habits of leaders who have presided over major corporate failures. Most of these

people may exhibit five or six of these habits and may well exhibit all seven.

Below is a summary of the seven habits identified by Finkelstein as those exhibited by leaders who presided over major corporate failures.

ONE

They see themselves and their companies as dominating their environments

Finkelstein indicated that *“They think they’re successful and that their company is successful because they made it happen”*. He stated that these leaders vastly overestimate the level of control they have over circumstances and believe that they are personally able to control things to ensure the company’s success. Such business leaders may use intimidating or excessive behaviour to dominate those around them. These leaders are so proud of their company’s product *“... they tell themselves, if you make the best product in the world, customers must either come to you or settle for something inferior”*.

TWO

They identify so completely with the company that there is no clear boundary between their personal interests and that of the company

According to Finkelstein, these leaders do not treat the company as something to be nurtured, protected and cared for but rather as an extension of themselves. Finkelstein described these leaders as people who feel personally responsible for the company’s success and that they could develop a *“private empire”* mentality, causing them to behave as if it’s their own company and act as though they have the right to do anything with the company. Finkelstein also indicated that failure of the company might be perceived by these leaders as an indication of their own inadequacy. Such leaders, according to Finkelstein, may be inclined to use corporate funds for personal reasons due to the rationalisation that everything they do is for the company.

THREE

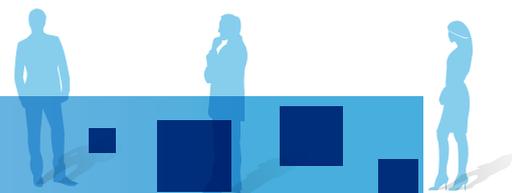
They think they have all the answers

Finkelstein indicated that nobody could have all the answers but that business leaders display an ability to make decisions amidst volumes of information and complex situations. He also indicated that leaders exhibit this habit as a means of protecting themselves from their personal lack of control over every situation.

⁹⁵ Fottrell – The CFO behind the Crazy Eddie’s fraud

⁹⁶ Finkelstein – Seven habits of spectacularly unsuccessful people

⁹⁷ Finkelstein – Seven habits of spectacularly unsuccessful people



FOUR

They ruthlessly eliminate anyone who isn't 100 percent behind them

These leaders, according to Finkelstein, believe that their vision should be instilled throughout the company to get everyone to work together to achieve the set goals. Leaders who have presided over major corporate failures often implemented a policy of removing those who were seen to undermine their vision and were likely to raise opposing views.

FIVE

They are consummate company spokespersons, obsessed with the company image

According to Finkelstein, these leaders are constantly in the public eye and have the ability to inspire confidence among the public, employees and particularly investors. Finkelstein is of the view that *"The public tendency to judge a CEO's success by the current price of the company's stock greatly reinforces this habit because the fastest and easiest way to improve the share price is to put on a good show for the media and investors"*.

Finkelstein also indicated that instead of running the company, these leaders leave the mundane business operations to others and treat the financial accounts

as a public relations mechanism instead of a control mechanism.

SIX

They underestimate major obstacles

Finkelstein indicated that such leaders become so obsessed with their vision that they see every challenge as minor and therefore neglect to consider the difficulties of actually achieving the goal. He stated that these leaders assume that all problems can be solved, when in reality, many problems cannot be solved or can only be solved at great expense.

SEVEN

They stubbornly rely on what worked for them in the past

According to Finkelstein, unsuccessful leaders often revert to what worked for them in the past in an effort to maintain control. Finkelstein stated that these leaders reach this *"defining moment"* at some point during their career when they achieved particular success. According to Finkelstein, their *"defining moment"* becomes their definition of success throughout their careers and to some extent they let it define their company as well.

The above summary of Finkelstein confirms the various themes observed in the case studies, ie that people who have specific characteristics, which,

given the appropriate opportunity, pressure and rationalisation, may succumb to the temptation of committing fraud.

Fraud seems so prevalent that the problem may appear insurmountable.

Although a number of commonalities have been observed throughout the chosen case studies, there is no exact science or method to predicting and preventing corporate fraud.

Policing fraud

Kelling and Wilson postulated the broken windows theory in 1982⁹⁸.

They suggested that:

- One broken window signalled that nobody cared and that breaking more windows would cost nothing
- *"... the sense of mutual regard and the obligations of civility are lowered by actions that seem to signal that 'no one cares'"*
- *"... serious street crime flourishes in areas in which disorderly behaviour goes unchecked"*
- The presence of police officers on foot patrol reinforced the informal control mechanisms of the community

⁹⁸ Kelling and Wilson – Broken windows

It is well known that Rudolph Giuliani (“Giuliani”), the former mayor of New York City, implemented the broken windows theory to reduce crime. Giuliani indicated that “... *you had to pay attention to small things, otherwise they would get out of control and become much worse*”⁹⁹.

Various other examples of the broken windows theory being successfully implemented are cited in the media.

On the other hand, much criticism has also been documented against the broken windows theory, stating that paying attention to the small things were not the only factors to be considered.

Nevertheless, in dealing with societal problems as serious as violent crime or fraud, one cannot simply turn a blind eye or accept that something sounding so simple will not work. Each of us have a responsibility to demand that things be done in a certain manner to maintain general order. If general order is maintained and a concerted effort is made to pay attention to the seemingly unimportant things, results will flow.

Considering the wide variety of causes observed in the corporate failure case studies, the challenge of detecting and deterring fraud is therefore not easy to solve due to the numerous role players, possible scenarios and the unpredictable nature of individuals. The obvious question is then how to apply the broken windows theory to corporates in an effort to detect and deter fraud.

The various themes identified in this publication as indicators of fraud provide insight into the various broken windows, ie:

- Non-independence of auditors
- Compromised quality of audit work due to reduced fees
- Deliberate actions and misrepresentations by management to delay or divert auditors’ attention from problematic areas
- Misconception of the role of an auditor and to what extent they are able to identify fraud through their audit procedures
- Poor or lack of corporate governance despite legislation and regulation, including non-independent and inadequately qualified board or committee members, lack of debate of business issues at board level and a deliberate disregard of legislation by management
- Unrealistic expectations of stakeholders for performance and growth or the fear of management to look like a failure and thereby disguising the true financial status of the company
- The capability of individuals to commit fraud by circumventing internal controls, using company finances for their personal benefit, dominance by the chairman or CEO and acting as though they are creating magic without feeling any remorse

⁹⁹ Interview - Rudolph Giuliani

Conclusion

Fraud was clearly not the reason for the corporate failures discussed earlier. Fraud was used to hide the truth of what was really happening and to convince investors and analysts that all was well.

The main reasons why the companies discussed in this publication reverted to fraud were to hide excessive debt, poor strategic decisions and the fact that the company was short of cash.

Creative and aggressive accounting, fraud and coercion can disguise the truth only for a while until the underlying problems it attempts to hide become so enormous that it cannot be hidden any longer.

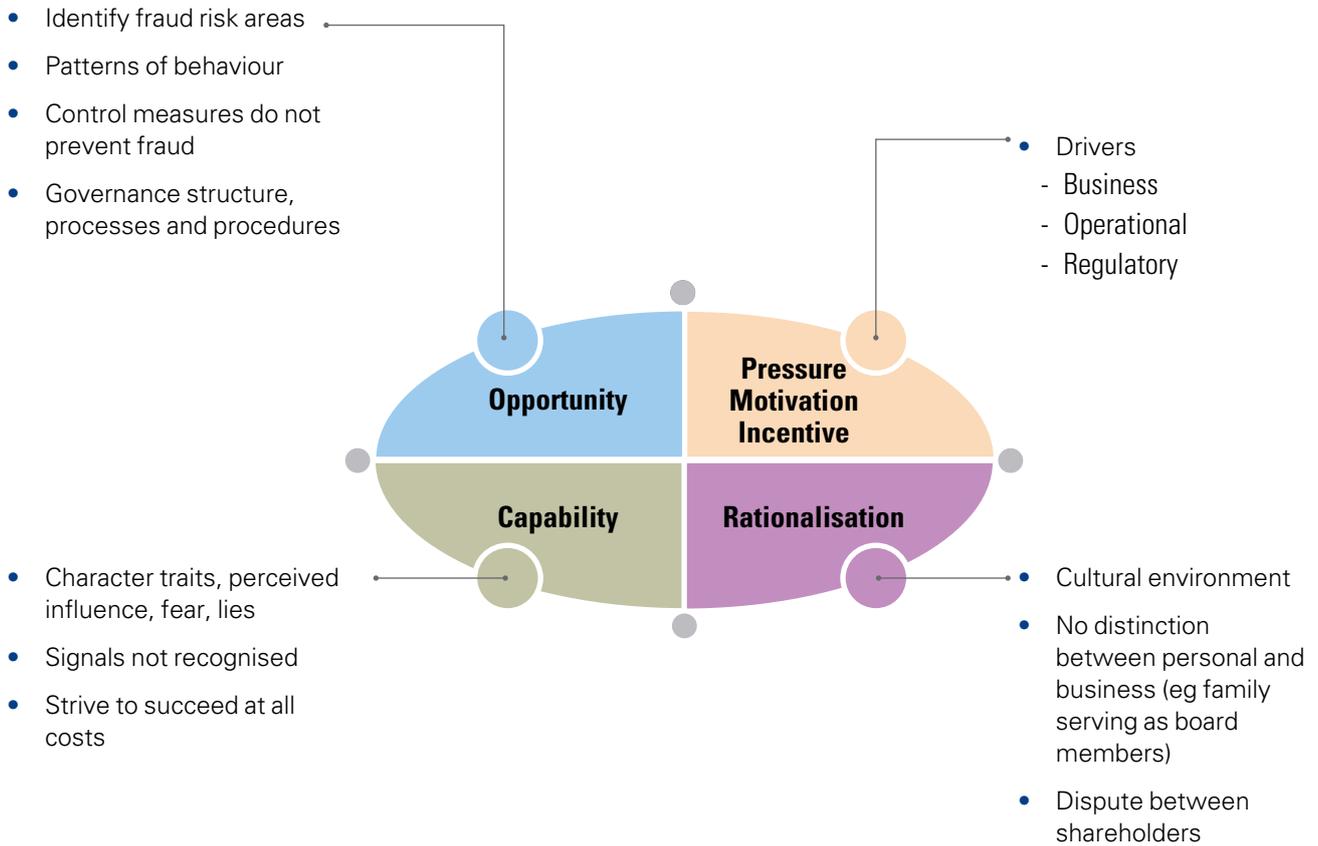
Regardless of the location of the various case studies considered, the same themes emerged in corporate failures that occurred across the world. Although many articles have been written about addressing each of the above issues separately, two clear themes have emerged, being:

- Certain areas that are specifically exposed to fraud and could be exploited if the elements of the fraud triangle are present
- Specific behaviours considered in conjunction with the organisation's culture may provide indications of the organisation's vulnerability and/or likelihood of fraud occurring

Conventional forensic investigations focus on obtaining evidence regarding a known or suspected incident. Two specific investigation strategies flowed from KPMG Forensic's Global Investigations Methodology to address the above two themes, namely Risk-Based Investigations and Behavioural Investigations. These types of investigations are pro-active in nature and aims to identify fraud risk areas, detect incidents of fraud, establish patterns of behaviour and determine which fraud elements are receiving too little attention in order to inform the client to better understand the organisation's susceptibility to fraud.



KPMG’s approach to Risk-Based and Behavioural Investigations focusses on the various elements of fraud, ie motivation/ pressure, rationalisation, opportunity and capability as depicted in the example below.



Risk-Based Investigations

The purpose of Risk-Based Investigations is to identify fraud risk areas, identify incidents of fraud, and establish patterns of behaviour where there may be suspicion of irregularities, where no specific incidents of fraud have been identified or where a starting point for a forensic investigation is not immediately obvious.

KPMG's approach to Risk-Based Investigations utilises a combination of forensic solutions in order to expand the organisation's understanding of fraud occurrences and the symptoms facilitating such frauds.

KPMG's Risk-Based Investigations approach includes:

- Obtaining an understanding of fraud risks and ethics through assessments, surveys and workshops. The people working within the organisation are best equipped to think about fraud risks and the likelihood of it occurring in their business. Skilled facilitators and forensic investigators could also challenge the audience to consider fraud risks that have been identified through process walk-throughs or interviews of key management. The results are useful in assessing the organisation's culture around ethics and whether specific risk areas may be centred in a single department
- Developing appropriate data analytics testing and performing data analytics procedures focussing on key ratios and underlying data. Many trends and anomalies have been identified during such data analytics procedures, for example, journals were processed by a particular user outside of office hours, ghost employees were identified through the comparison of employee master data, payroll data and electronic funds transfer data and there was no correlation between items such as sales, cost of sales and inventory
- Investigating risk areas identified through the initial phases to determine if fraud incidents occurred, whether the incidents identified were isolated incidents or form part of a pattern of behaviour
- Reporting findings to enable the organisation to institute appropriate action, reporting non-compliance in terms of legislation or regulations and facilitating process, procedural and governance improvements



Behavioural Investigations

It is commonly known that the management of any organisation is responsible to prevent and detect fraud. However, when fraud is committed by management, their ability to influence people and to disguise the true nature of the events facilitates the occurrence of fraud.

The purpose of Behavioural Investigations would therefore be to establish the behaviours manifesting in an organisation with due consideration of the code of conduct and various governance structures. The organisational culture may be enabling fraud as it promotes certain behaviours, particularly where conventional control measures are not sufficient to prevent fraud.

Behavioural Investigations therefore assess those traits and perceptions of others of deviations from desired behaviour that may indicate an endorsement of inappropriate use of company assets, a culture of unethical conduct being overlooked or even condoned and whether there is an active realisation of the organisation's and shareholders' interests.

Interviews form an important part of Behavioural Investigations in order to obtain a view of, *inter alia*:

- Character traits of management and the perceptions of others regarding the example set by management of ethical conduct
- Elements of the organisational culture that may be promoting certain behaviours
- How concrete, accurate and complete the governance structure, processes and procedures are
- Deviations from the desired behaviour (eg per the code of conduct)
- Whether employees and/or management are called to task about unethical behaviour
- Whether the interests of the organisation and stakeholders are actively pursued

Behavioural Investigations could therefore include:

- Reviewing the governance structures to assess their effectiveness through document review and consultation. During a forensic investigation it was found that the tone at the top is seriously affected by ineffective governance structures. Poor governance creates tension and mistrust, which leads to factions within the organisation trying to undermine the efforts of the other instead of working towards a common purpose. This creates the breeding ground for people having a sense of entitlement to act in a certain way even if it is illegal, immoral or simply wrong
- Asking further in-depth questions about the company strategy, relationships between board members, service providers and board committees. A breakdown of these relationships may indicate attempted influence by the client over the audit procedures or other service providers/suppliers to collude in committing fraud, for example, by requesting suppliers to deliver inventory without processing the invoices at the correct time

- Assessing the potential influence of management over auditors. Although auditors have a responsibility to consider fraud, there may be limitations in their ability to detect fraud due to the intentional actions by management to disguise the truth, for example, supporting documents could be created by management and may be accepted on face value as sufficient proof of a transaction. This behaviour was observed during a forensic investigation where the management of a subsidiary went as far as manipulating inventory count sheets to match the fiddled management accounts being submitted to the holding company
- Identifying and exploring fraud risk areas. Experience has shown that individuals who are dissatisfied with certain procedures or decisions have a tendency to disregard policies and “bend” the rules or “expedite” transactions in a particular way. This creates the impression that everybody could get away with inappropriate behaviour and more loopholes may be exploited by others in the organisation

Summary

Not one single person, entity or body can be held responsible for fraud.

Du Toit also stated that¹⁰⁰
“If one accepts that fraud is always a possibility, it becomes clear why everyone, including parties external to the operations of a company, should make an effort to prevent, detect and identify cases of fraud”.

The collection of investors, shareholders, financial institutions, regulators, analysts and auditors need to be responsible for the prevention and detection of fraud.

Despite what fraudsters may believe, they have not created any sort of magic.

The truth of fraud is that it is deliberate and exploitive in a number of ways.

¹⁰⁰ Du Toit – Using financial analysis and interpretation as a foundation to comprehend financial health

Appendix 1

- Background to global case studies

Below is a synopsis of the various case studies considered and referred to in this publication, including the following countries:

- USA
 - Crazy Eddie Incorporated (“Crazy Eddie”)
 - Enron Corporation (“Enron”)
 - WorldCom Incorporated (“WorldCom”)
 - Adelphia Communications Corporation (“Adelphia”)
- Australia
 - Health International Holdings Insurance Limited (“HIH”)
 - Bond Corporation (“Bond”)
- India
 - Satyam Computer Services (“Satyam”)
- South Africa
 - JCI Limited (“JCI”)
 - Macmed Healthcare Limited (“Macmed”)



USA

Crazy Eddie

Crazy Eddie traded as a private family-run business from 1969 to 1979 as a consumer electronics retailer¹⁰¹. Sam Antar (“Antar”), who started working in the family business as a stock boy, described the various frauds committed by the family as a matter of course. The frauds initially included skimming cash sales to avoid income and sales taxes, employees were paid in cash “*off the books*” to avoid payroll taxes and “*phony or exaggerated*” insurance claims were reported to inflate profits. When Antar attended college to study accounting, the family paid his tuition and full-time salary, as they believed Antar’s education would help them execute more sophisticated financial crimes.

After graduation, Antar worked at the accounting firm that audited the books of Crazy Eddie. He continued working at Crazy Eddie to help implement a plan to list Crazy Eddie as a public company. Antar was paid “*off the books*” by Crazy Eddie to conceal his employment while working at the accounting firm.

Crazy Eddie gradually reduced the skimming of cash sales from 1980 to 1984, which resulted in Crazy Eddie reporting growth from \$1.7 million (1980) to \$8 million (1984).

On 13 September 1984, Crazy Eddie had its initial public offering and 1.7 million shares were issued at \$8 per share.

During 1985, Antar obtained his Certified Public Accountant (“CPA”) license and was appointed by Crazy Eddie. He was no longer being paid in cash.

Enron

Kenneth Lay created Enron in 1985 through the merger of two natural gas pipeline companies¹⁰². The company grew extensively during the 1990s. Jeff Skilling (“Skilling”) was the President and Chief Operating Officer (“COO”) of Enron and, eventually, the Chief Executive Officer (“CEO”) for six months until he resigned in 2001, just four months prior to Enron’s demise. At the time of Enron’s demise, it had over 3 000 subsidiaries and unconsolidated associates¹⁰³.

Enron *inter alia* adopted the “*mark-to-market*” accounting model to recognise future revenue and used special purpose entities to fund the acquisition of gas reserves¹⁰⁴. “*Mark-to-market*” accounting allowed Enron to recognise the expected profits on long-term contracts¹⁰⁵. In some instances, Enron was the only supplier of certain products, which left the door open to price manipulation.

¹⁰¹ Antar – White collar fraud

¹⁰² Khan – The reasons behind a corporate collapse

¹⁰³ Hamilton and Micklethwait – Greed and corporate failure

¹⁰⁴ Khan – The reasons behind a corporate collapse

¹⁰⁵ Hamilton and Micklethwait – Greed and corporate failure

The investors in special purpose entities included Enron employees who profited from the sale of gas reserves¹⁰⁶. The substance of the underlying transactions involving the various special purpose entities was important but not adequately disclosed and therefore constituted misrepresentation and fraud¹⁰⁷.

WorldCom

Bernard J Ebbers ("Ebbers") was the former CEO of WorldCom¹⁰⁸. He obtained a degree in physical education. After coaching basketball for a number of years, he bought a motel and expanded the business to seven motels within 10 years, based on a business model focussing on tight cost control.

Ebbers had no formal business education and tapped WorldCom for loans to finance his private businesses¹⁰⁹. Ebbers had built up his own empire of businesses and as a result accumulated large amounts of debt, with WorldCom stock as security. When the WorldCom share price decreased in 2000, Ebbers received repayment demands. He turned to WorldCom for a short-term loan. The board approved various loans to Ebbers with below-market interest rates, which he used as working capital for his own businesses. Initially, WorldCom accepted only Ebbers' stock in WorldCom as security for these loans and only later insisted on Ebbers putting up some of his outside interests as collateral.

WorldCom acquired some 60 entities over 15 years but was not able to integrate these successfully; adding to the problems¹¹⁰.

WorldCom manipulated its accounting records as follows¹¹¹:

- Adjustments to revenue through the use of a schedule that became known as "*Close the Gap*", which became a theoretical exercise of tracking and correcting the shortfall between budgeted and projected revenue¹¹². Scott Sullivan ("Sullivan"), CFO since 1994 and board member since 1996, held monthly revenue close meetings that lasted several hours
- Manipulation of line costs; these adjustments were made after quarter close and often did not have supporting documentation¹¹³. Employees were intimidated into processing these entries but as resistance from employees grew, Sullivan had to find alternative ways of decreasing line costs, which led to the capitalisation of expenses. Capitalisation of expenses was suggested by Tony Minert ("Minert"), a CPA, during 2000. The idea was dismissed and Minert left WorldCom shortly afterwards. However, less than a year later, the first entries to capitalise line costs as "*pre-paid capacity*" appeared, again without supporting documentation

- An internal auditor at WorldCom, Gene Morse ("Morse"), followed a \$500 million entry on the Property Plant and Equipment schedule through the accounting system and realised that it came from the income statement¹¹². Through his analyses, Morse identified entries processed over weekends and round figures used for adjustments¹¹⁴
- Retroactively adjusting budgets¹¹⁵

Adelphia

John Rigas paid \$100 for a cable television franchise during 1952 and Adelphia was founded¹¹⁶. It was run as a family business and grew steadily from 25 customers in 1952 to 6 000 customers in 1972. During 1986, Adelphia was listed on the NASDAQ stock exchange. The company expanded into internet and telecommunications during the 1990s. It used a combination of cash, stock and debt to fund the acquisitions.

During 2002, Tim Rigas, the Chief Financial Officer ("CFO"), revealed that John Rigas and other family members, through various partnerships, owed the company \$2.3 billion, which were not all disclosed in the records of Adelphia¹¹⁷. The United States Securities and Exchange Commission ("SEC") launched an investigation and Adelphia filed for bankruptcy later in 2002.

¹⁰⁶ Hamilton and Micklethwait – Greed and corporate failure

¹⁰⁷ Greer and Tonge – Ethical foundations: A new framework for reliable financial reporting

¹⁰⁸ Hamilton and Micklethwait – Greed and corporate failure

¹⁰⁹ Hamilton and Micklethwait – Greed and corporate failure

¹¹⁰ Hamilton and Micklethwait – Greed and corporate failure

¹¹¹ Hamilton and Micklethwait – Greed and corporate failure

¹¹² Zekany et al – Behind closed doors at WorldCom

¹¹³ Hamilton and Micklethwait – Greed and corporate failure

¹²² Zekany et al – Behind closed doors at WorldCom and Wells – The quarter-million-dollar caper

¹¹⁴ Wells – The quarter-million-dollar caper

¹¹⁵ Hamilton and Micklethwait – Greed and corporate failure

¹¹⁶ Van Peursesem et al – Three cases of corporate fraud: an audit perspective

¹¹⁷ Van Peursesem et al – Three cases of corporate fraud: an audit perspective

Van Peurse et al categorised some of the fraud activities at Adelphia as follows¹¹⁸:

- Debts were disguised in unconsolidated subsidiaries. The company created fictitious documents as proof that debts had been repaid
- Key performance indicators, such as the number of cable subscribers, were overstated by including the numbers of subscribers for internet and other services
- The Rigas family benefited significantly from obtaining \$1.3 billion in company stock, using \$241 million of company funds to repay personal debts, the payment of \$26.5 million for *"timber rights on a Rigas property to preserve the view outside the Rigases' family home"* and spending \$12.8 million of company funds to build a golf course and club house for exclusive use by family members



Australia

HIH

During 1968, Ray Williams ("Williams") and Michael Payne established a small insurance business. HIH was listed on the Australian Stock Exchange during 1992¹¹⁹. From 1998, HIH embarked

on a plan to increase its market share through expansion. HIH purchased FAI Insurances Limited ("FAI") without board consultation or the completion of a due diligence report. FAI's assets were over-valued and a premium was paid to gain control of the company. According to Mak et al (2005), the company grew too quickly and was overextended on debt after the FAI acquisition¹¹⁹. HIH paid A\$300 million for FAI, which required HIH to borrow extensively to fund the acquisition¹²⁰.

During 2001, the Australian Stock Exchange suspended trading in HIH. The accumulated loss from the collapse of HIH was A\$5.3 billion.

HIH had more than 250 subsidiaries at the time of its liquidation¹²¹.

Van Peurse et al indicated that the following led to the failure of HIH¹²²:

- Business factors such as over-priced corporate acquisitions and corporate extravagance through a culture of *"money was for spending"* including personal expenses charged to credit cards, generous corporate gifts and excessive travel expenses
- Accounting failures caused by lack of adequate provisions for future claims, acquisitions without appropriate due diligence procedures and management fraud

Bond

Alan Bond ("Bond") established a business empire including a brewery, a media company and worldwide interests in property and mining¹²³. Bond borrowed heavily to grow his empire and fund his extravagant lifestyle. Bond's frauds included paying himself excessive fees, taking large profits and selling assets to related entities at hugely inflated prices. Eventually, Bond faced serious cash flow and liquidity problems due to the massive debts and reluctance by others to lend him money.



India

Satyam

Satyam Computer Services Limited, an Information Technology ("IT") services company, was established by Ramalinga Raju ("Raju") in 1987¹²⁴. Satyam embarked on a variety of business growth strategies and reported favourable financial results. It was listed on the Bombay Stock Exchange in 1991 and on the New York Stock Exchange ("NYSE") during 2001. Aggressive growth strategies took the company from a private company with 20 employees in 1987 to a listed company in 2008 with over 45 000 employees¹²⁵.

¹¹⁸ Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹¹⁹ Mirshekary et al – Australian corporate collapse: the case of HIH Insurance

¹²⁰ Mak et al – Australia's major corporate collapse: Health International Holdings (HIH) Insurance "May the force be with you"

¹²¹ Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹²² Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹²³ Van Peurse et al – Three cases of corporate fraud: an audit perspective

¹²⁴ Bhasin – Corporate accounting scandal at Satyam: A case study of India's Enron

¹²⁵ Basilio et al – Asia's Enron: Satyam (Sanskrit word for truth)

It was an example of “India’s growing success” and won numerous awards for corporate governance, innovation and corporate accountability¹²⁶. Less than five months after winning the Global Peacock Award for corporate accountability, the fraud scandal at Satyam was revealed.

Raju announced on 16 December 2008 that Satyam would purchase Maytas Infrastructure and Maytas Properties for \$1.6 billion¹²⁷. Raju’s two sons owned the Maytas companies, which businesses were unrelated to the core business of Satyam. After investors expressed their dissatisfaction with the announcement, the decision to purchase the two Maytas companies was withdrawn.

Raju, the chairman of Satyam, committed fraud and manipulated financial statements over a period of 10 years¹²⁸. Ironically, Satyam means “truth” in the ancient Indian language “Sanskrit”.



South Africa

Little published literature is available in professional journals or books regarding South African corporate failures. Du Toit cited a number of media articles referencing some of the reasons for the corporate failures of a number of South African companies, ie JCI and

Macmed¹²⁹. Further media searches were performed on the aforementioned companies to form an understanding of their demise.

JCI

According to media articles cited by Du Toit, JCI was unable to sustain a positive cash flow and looked “very much like a company knocked together with debt”¹³⁰. The fraud was perpetrated by the former directors of JCI over a number of years and included the overstatement of assets and manipulation of internal controls.

Macmed

Media articles cited by Du Toit indicated that Alan Hiscock, the former company secretary, was the mastermind of the fraud to disguise the dire financial situation of the company in order for its directors to cash in on share options and banks to continue lending it money¹³¹. Amongst other frauds, fictitious invoices were raised in the name of a subsidiary to inflate profits.

Macmed allegedly borrowed R1 billion from a total of 13 banks. A portion of these funds allegedly went to directors. When Macmed tried to raise further funds, the various fraudulent transactions were discovered, resulting in its suspension from the Johannesburg Stock Exchange (“JSE”) on 30 September 1999. Apparently, the 1998 and 1999 financial results did not resemble Macmed’s true financial position¹³².



¹²⁶ Bhasin – Corporate accounting scandal at Satyam: A case study of India’s Enron

¹²⁷ Basilico et al – Asia’s Enron: Satyam (Sanskrit word for truth)

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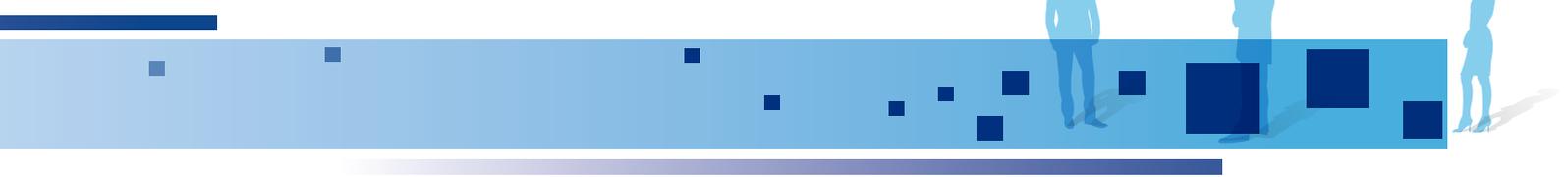
¹³¹ Du Toit – Using financial analysis and interpretation as a foundation to comprehend financial health

¹³² Rose – Scorpions swoop on Macmed top brass

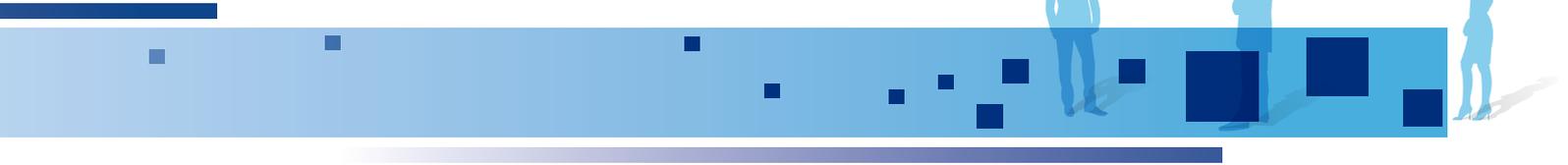
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Appendix 3 - About the authors

Cornelia Niemand

Cornelia is passionate about South Africa, the growing economy and upholding the reputation of South Africa as a great place to live and work. She has seven years' commercial experience in financial accounting and financial management, three of which were at KPMG. During 2001, Cornelia felt compelled to make a difference in a more constructive way and joined KPMG's dynamic and renowned Forensic business unit. After 14 years of dedicated forensic investigations experience, Cornelia is still passionate about her work and her country. She is self-admittedly surprised at the variety of frauds people have perpetrated and the ripple-effect it has on the organisations, people's trust and the economy. However, this does not deter her from being a devoted forensic investigator. By sharing her skills, knowledge and experience she has executed and led several teams to conduct forensic investigations of high quality. She firmly believes that the results of her work product can and has made a difference where there was concerted effort to address the issues.

Cornelia has work and forensic experience in a variety of industries including, among others:

- Government, Health and Infrastructure
- Law enforcement
- Education
- Financial services
- Communications, Electronics and Entertainment
- Manufacturing
- Retail
- Mining

Estelle Wickham

Estelle completed her articles and was an audit manager for 2 years. She then joined the KPMG Forensic Team in 2007, She has been doing investigations in various capacities for the last 8 years including various responsibilities such as project planning, budget monitoring, drafting reports and providing feedback to clients. She has managed small teams of 3 staff members up to a big team of 65 staff members. She serviced clients in all industries.

Estelle is passionate about understanding her client's needs. Ensuring that she understands the facts embedded in the issues, in order to deal with it in a timely and efficient manner. She believes that even though you learn from previous investigations, each investigation has its own characteristics/circumstances and deserves a unique approach to effectively address the matter at hand. Besides investigations, Estelle is also responsible for the forensic investigations training programme at KPMG.

Estelle specialises in services delivered to:

- Financial services
- Public sector
- Law enforcement
- Regulatory authorities



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