

Forensic Accounting, Enron, Worldcom and How You Can Prevent Investing in Frauds

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Let's talk **forensic accounting**.

First.

Ever been scammed?

Maybe not, but I'm sure you've been targeted.

About 5 years back, a wealthy Nigerian man called me asking for money because he was in a business deal where he was unable to use his name. If I fronted up the cash, I would be rewarded \$10m dollars.

Thinking back, maybe the guy really meant \$10m Zimbabwean dollars.

Well, I was bored at the time so I went along with the story to see how the whole thing would unfold.

Over the next couple of days via email, the guy would weave tale after tale of how his grand scheme would work.

I don't recall the details, but in the end, he gave me an address where I had to send a package but instead, I went to the FBI fraud website and submitted a fraud report instead.

I have no idea how it all ended, but in the stock market, you get these kinds of hamsters too.

The reverse Chinese mergers showed you just how easy it was for people to get scammed.

Heck.

Even [I fell for it](#). (I hate how all this evidence is still available on the blog lol)

Obviously, fraud is much more difficult to detect in the stock market, but since my last mistake I've put up basic systems in place to prevent it from happening again.

You probably have a smoke detector in your home that guards against fires.

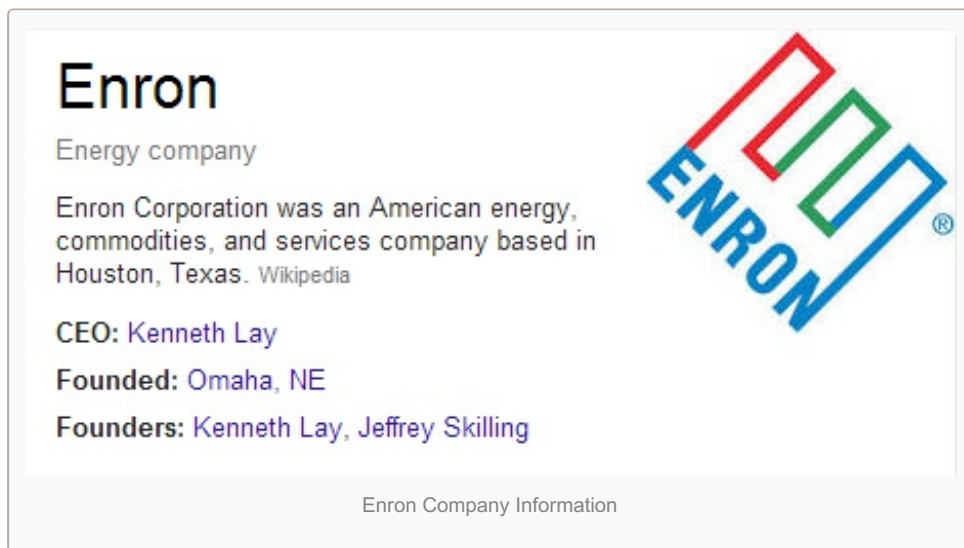
But do you have what it takes to guard yourself against investment fraud?

The only way is to get familiar with **forensic accounting** and financial statement analysis.

Forensic Accounting Could Have Saved Investors from Enron and Worldcom

In 2001 and 2002 the financial world was rocked by two huge scandals.

Enter Enron.



There are other places where you can read about the detailed history of Enron, so I'll keep it brief.

In 2001, the gigantic energy company filed a \$618 million third quarter loss.

In order to cover up their huge losses, Enron used their auditing firm, Arthur Andersen, to doctor their financial statements by taking advantage of lax US GAAP rules.

By making the financial statements as complex as possible, analysts and investors couldn't understand what they were looking at.

Add all the "special purpose" entities and to mask their financial reports, and they were able to hide billions of dollars in debt.

Financial statement analysis was impossible.

It was only for a short time, because there are only so many places you can hide an elephant.

Eventually the SEC and its pack of forensic accountants shredded them to pieces.

Here's a high level overview of what the forensic accounting team found:

- Shady and overly complex accounting schemes
- Misrepresentation of financials
- Company leaned on Andersen to abandon honest accounting practices
- Credit rating and stock price were deliberately inflated

Another interesting loophole that Enron abused were partnerships.

In fact, Enron established 3,000 partnerships starting from 1993.

The big loophole back then was that as long as Enron could develop partnerships where it had at least a 3% stake, the company was not required to report the partnerships financial condition in its own balance sheet.

But how on earth did Enron pressure Arthur Andersen to start fudging numbers?

Auditing policies were looser compared to now because Arthur Andersen wasn't just an independent auditing company to Enron.

1. Arthur Anderson consulted Enron
2. Arthur Anderson self-policed themselves – there was nobody to say anything
3. The auditor appointment usually went through senior management

Clearly too many hands in the cookie jar.

The Worldcom Scandal

Troubles started surfacing for Worldcom in 1998 when the telecom industry was in a sharp decline.

Worldcom's main growth strategy was to go on a major acquisition spree, so with the market declining, that growth strategy went out the window.

To offset these losses, instead of either writing down goodwill or simply taking a loss, Worldcom decided it wanted to make use of its creative cooking skills.

"Worldcom's Easy 15 Minute Cooking the Books Recipes" was a hit with Wall Street before the deteriorating financial situation was too much to bear.

Unlike Enron's complex cookbook, Worldcom just had two steps.

1. Line cost was under-reported by capitalizing it rather than properly expensing it on the balance sheet
2. Revenues inflated like a balloon with fake accounting entries classified as "corporate unallocated revenue accounts"

Two simple fraudulent accounting changes had the following effects to the company.

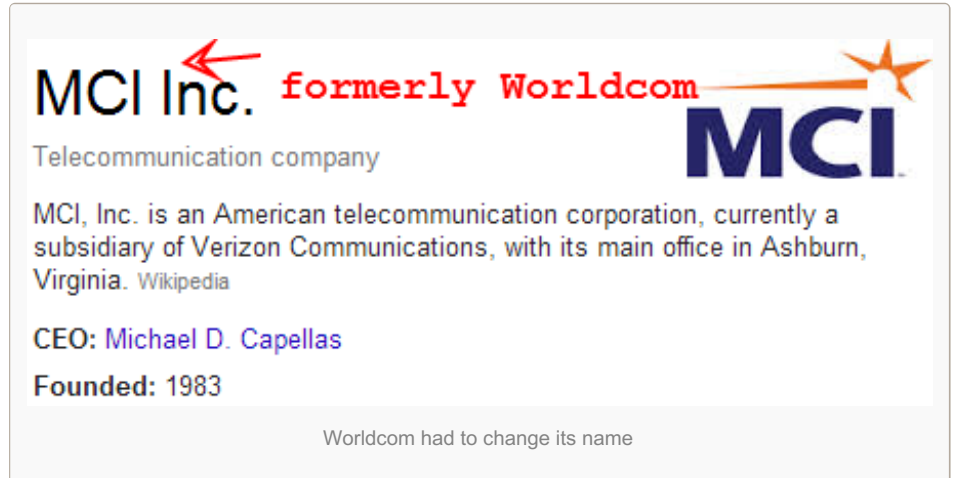
- Net income went up
- No change in revenue
- No change in COGS
- Big decrease in computer expenses
- Big decrease in company phone networks

Thankfully a small group of internal forensic accounting auditors worked in secret to reveal the fraud.

America at its finest.

What's the Point of These Two Case Studies?

1. Case studies are awesome
2. Learn from past mistakes



The government learned from what happened to Enron and Worldcom and promptly implemented the [Sarbanes–Oxley Act](#).

As an investor, you can implement something like a “Forensic Accounting Act” or the “Perform Financial Statement Analysis for Fraud Prevention Act”.

Just some form of set of rules or processes to make sure you have your backside covered.

This sounds like a lot of hard work, but a lot of the work has already been done for you. There are checklists and lists of points to check which I’ve linked to at the bottom.

But first, here are the main areas of financial fraud used by forensic accountants.

Five Distinct Categories of Financial Fraud

Segmenting financial fraud into topics

1. Fictitious Revenues
2. Improper Revenue Recognition
3. Concealed Liabilities
4. Related Party Transactions
5. Improper Valuation of Assets

A lot of this can be detected by fine combing through the SEC filings.

It’s not easy with the naked eye, but that’s why I have a tutorial on how you can easily [detect the changes between two filings and footnotes](#).

Fictitious Revenue

Everything in this section is related to bogus revenue.

Companies will manipulate transactions or just create it out of thin air to increase reported earnings.

Companies can do this easily by creating fake customers and sales. You can even fake sales with a legitimate customer with a phony invoice or “accidentally” increasing the quantity or price.

It comes back in the next accounting period because customers will want a credit for the honest “mistake”.

Some more things to look at.

1. **Rapid growth with unusual profitability numbers** – Keep an eye on trends over long term periods instead of placing too much trust on a single year.
2. **Solid growth while competition and industry is lagging** – Sure this could be a sign of exceptional execution, but when everyone else is falling on hard times, it looks fishy to be the only one showing positive growth.
3. **Big related party transactions** - It’s so easy to fake revenue with related parties. The company could receive a rent payment, or get money for some service it performed to the related party a while back. If you have a good imagination, anything is possible. More on this later.

4. **Extend periods of negative cash from operations while net income is positive** – This red flag applies to many other areas. The income statement may show that the business is doing exceptional, but remember that cash is king. Follow the cash and you'll drastically increase your own forensic accounting skills.

Improper Revenue Recognition

Inflating revenue numbers is a drug. Once you start, it's addictive and difficult to stop.

In fact, there's a statistic stating that [40% of all financial statement fraud](#) involves revenue recognition schemes.

So watch out.

Here's a list of 8 red flags on revenue recognition to help you out.

1. **Fake future sales for obsolete goods** – Very much linked to inventory fraud.
2. Huge upswing in performance during the last fiscal year to meet analyst expectations.
3. **Early delivery of products** – Includes things like shipping before the customer's requested shipping date, shipping unfinished products or in partial shipments.
4. **Incorrectly recognizing full revenue** – The contract may state that multiple deliverables and milestones must be met but the full revenue may be booked in the financials.
5. **Channel stuffing** – This is where a company sends excess products to retailers fully knowing it won't be sold, but simply to inflate sales. You usually notice this type of deceptive practice when accounts receivables balloons out of control.
6. **Bill and hold arrangements** – This is where the customer is billed but the inventory is not shipped. i.e. it's still held in inventory. Maybe they will send it to an external warehouse, but still not a proper revenue recognition policy.
7. **Using related party transactions to sell to one other to inflate sales** – See the section on related party transactions.
8. **Misclassification** – Combining unusual, extraordinary, and nonrecurring gains as income from continuous operations. Anything that is a one off type of transaction must be separated out.

Concealed Liabilities

Nobody likes a company that is filled with debt.

Companies loaded with debt know this too and that's why they try to hide it.

The idea here is simple. If debt is hidden, then equity, assets and earnings become inflated.

Concealed liabilities can include things like warranties, unpaid pensions, and shifting liabilities as off-balance sheet liabilities.

A red flag for concealed liabilities is going to be any significant estimate that requires subjectivity to determine the total amount.

To protect yourself against falling into this trap, you want to compare with other companies in the same industry by using balance sheet ratios like the current ratio and debt to equity ratio or liabilities to equity ratio.

Related Party Transactions

This isn't always a red flag. Related party transactions can be common among family owned businesses so it isn't a bad thing.

But you should be worried when you see signs that the company is trying to use it as a piggy bank.

I mentioned earlier that having a wild imagination helps with related party transactions because anything could be deemed as a purchase or sale transaction.

Did you know that it's also easy to transfer liabilities to related affiliates?

Detecting these types of transactions is difficult though and the best resources that you have is combing through the filings to see whether you find any evidence of related party transactions.

Improper Valuation of Assets

The more assets a company has, the better it looks to shareholders, creditors and lenders.

The most commonly abused assets are inventory, accounts receivables and fixed assets.

Inventory is prime territory to mess around because it is so complex.

For example, unlike your next door mom-n-pop store, inventory can be located in multiple locations and consist of thousands of items. It's easy and entirely possible to shift inventory from one place to another and double count it.

It's hard to admit, but investors start at a disadvantage. You are usually the last to get news and by the time it reaches you, it's too late.

Damage done.

But there are ways to know the warning signs to help you escape before your portfolio explodes.

Keep an eye for these.

1. Booking sales before the product is shipped.
2. Counting inventory that has already been sold.
3. Counting inventory owned by 3rd parties.
4. Disparity between inventory to cost of goods sold and accounts receivable to sales.
5. Overstated lifespan of assets thus decreasing annual depreciation expense.
6. Recurring negative cash flows from operations.
7. Unable to generate cash flows from operations but EPS and earnings growth goes up.
8. Unusual increase in gross margin, or margin in excess of industry peers.
9. Unusual growth in the number of days' purchases in inventory.
10. Insurance coverage that is less or greater than the inventory shown on the balance sheet.
11. Significant upward inventory adjustments at locations that were not observed by the auditors compared to the locations that were observed.
12. Changing the inventory valuation method (LIFO to FIFO) without disclosure of the change.

Forensic Accounting is a Beast

I'm hitting 2,000 words here, which is about 4.5 pages of text, but I'm only scratching the surface.

There is so much more that I haven't covered and can't possibly cover in a single post. Forensic accounting is a beast of a topic to cover.

Unless you know a particular company or industry inside out, it's going to be difficult to verify everything.

But take a slow read through everything again and get familiar with the common financial statement frauds.

More Financial and Accounting Shenanigans

To give this topic justice, get a copy of Howard M. Schilit's book, [Financial Shenanigans](#).

You get better explanations, case studies and more practical forensic accounting methods.

[Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports, 3rd Edition](#)

List Price: \$34.95

Current Price: \$16.95

About Jae Jun

Jae Jun is the founder of Old School Value. He is on a mission to provide practical and actionable value investing tools, tutorials and educational material to help empower the individual investor. Keep in touch with Jae via any of the methods linked below.