FAIR VALUE ACCOUNTING FRAUD

New Global Risks & Detection Techniques

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John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Zack, Gerard M.
Fair value accounting fraud : new global risks and detection techniques/Gerard M. Zack.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-470-47858-5 (cloth)
1. Misleading financial statements. 2. Accounting fraud. 3. Fair value–Accounting. I. Title.
HF5681.B2Z234 2009
657'.3–dc22

2009010848

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

This book is dedicated to my brothers, Bill and Ray. I am so lucky to have two brothers who have always been such great role models and who continue to be so deserving of my admiration and respect, yet who are also my best friends. I love you both dearly.

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Preface

Depending on what you have read and who you have listened to, you may have formed the opinion that fair value accounting has had one or more of the following relationships with the global financial crisis that continues to worsen in 2009:

- It was one of the direct causes of the crisis.
- It exacerbated the crisis, which was initially caused by other factors.
- It hid or disguised the crisis for months, resulting in a delayed initial response to the crisis.
- It had nothing to do with the crisis—but it sure is fun to blame crises on accountants.

Fair value accounting is the accounting profession's equivalent of the automobile commercials you have seen on television, showing a vehicle racing around an obstacle course or bouncing over hills, along with a disclaimer saying something to the effect that "This is a professional stunt driver on a closed course. Do not try this at home!"

Fair value accounting is not for the timid. It is often not precise. It makes some people uncomfortable (they are called auditors). It involves a tremendous amount of judgment and estimation. It also frequently requires a highly specialized expertise. And whenever accounting involves a significant amount of judgment and estimation, it becomes infinitely more susceptible to manipulation and fraud.

The role that fair value accounting may have played in connection with the current economic mess is an interesting one to debate, but is not really the subject of this book. The issue that cannot be disputed, however, is that the accounting rules regarding the use of fair value accounting are extremely complicated. This complexity has most certainly led to inconsistencies in the application of these rules. While most of these inconsistencies are likely the result of honest mistakes and, in some cases, a poor understanding of the rules, some will inevitably be determined to be more deliberate. As a result, there are bound to be many cases of fair value accounting fraud in the coming years. Financial reporting fraud is nothing new. But the techniques used to perpetrate it change over time. And one of the trade-offs for the many benefits of fair value accounting is that it is likely to be the basis for some of the next major financial reporting frauds.

Regardless of whether you favor or dislike the use of fair value accounting, one thing most people agree on is that the rules are very complicated. In its December 2008 report on the use of fair value accounting in the United States, the Securities and Exchange Commission soundly endorsed the use of fair value accounting. It even encouraged the expansion of fair value applications in the financial statements. However, the SEC cautioned that better, more practical guidance is badly needed, and some of the fair value accounting standards are in of need clarification and simplification. Starting in January 2009 and continuing into April, the Financial Accounting Standards Board has taken steps to respond to the SEC's mandate for improved guidance. No doubt, additional guidance is on the way. The accounting standards are far from perfect, but as FASB and the International Accounting Standards Board continue to work together, greater consistency and clearer rules will hopefully result.

It is with the complexity of these rules in mind that I have chosen to tackle the subject of fair value accounting fraud with this book. The rules in the United States share many attributes with the rules used in countries that recognize the International Financial Reporting Standards. Yet there are many differences as well.

The purpose of this book is to raise awareness of the many risks of fraud based on how fair value accounting is utilized in the preparation of financial statements and how those applications differ under U.S. and international accounting standards. This book is not a guide on how to perform valuations. But it is designed to provide readers with an overview of the fair value applications and some of the most commonly used methods, especially as these subjects relate to the primary focus of this book—the risk of financial reporting fraud.

Gerard M. Zack
April 2009

How This Book Is Organized

This book is organized into five parts:

Part I Introduction to Fair Value Accounting Fraud
Part II Asset-Based Schemes
Part III Liability-Based Schemes

Part IV Other Fair Value Accounting Fraud Issues
Part V Detection of Fair Value Accounting Fraud

Beginning in Chapter 2 and continuing through the end of Part IV, as fraud schemes are introduced, each will be highlighted in a special fraud risk text box. Each fraud scheme has been assigned a number, the first part of which corresponds to the chapter number. The fraud risks identified in Chapters 2 and 3 are broad risks that could apply to any application of fair value accounting. The risks identified in Chapters 4 through 21 are specialized risks associated with the specific accounting topic addressed in each chapter.

In the sections of the book surrounding each fraud risk text box, the details of the accounting rules and how those rules would be violated in connection with each fraud scheme are explained. All of the fraud schemes are listed in Appendix A for your reference.

Glossary of Abbreviations Used in This Book

Numerous acronyms and abbreviations are used throughout this book, starting in Chapter 2. Here are some of the most commonly used abbreviations. Each will be explained further as they are introduced in the book.

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
EITF	Emerging Issues Task Force
FASB	Financial Accounting Standards Board
FIN	FASB Interpretation
FSP	FASB Staff Position
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASCF	International Accounting Standards Committee Foundation
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards (issued by IASB)
ISA	International Standard on Auditing (issued by IAASB)

PCAOB	Public Company Accounting Oversight Board
SAS	Statement on Auditing Standards (issued by AICPA)
SEC	Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concepts (issued by FASB)
SFAS	Statement of Financial Accounting Standards (issued by FASB)
SIC	Standing Interpretations Committee
SOP	Statement of Position (issued by AICPA)

Acknowledgments

I want to thank April for many things, but especially for the love and support you have provided to me during a challenging period in my life. Words cannot adequately express my appreciation and love.

I also want to thank the great team at John Wiley & Sons, specifically:

Tim Burgard, Acquisitions Editor
Lisa Vuoncino, Production Editor
Helen Cho, Senior Editorial Assistant

You have made this process feel very much like a team effort.

PART I

Introduction to Fair Value Accounting Fraud

In this introductory section, the most important concepts of financial statement fraud and fair value accounting are introduced. To understand how to detect fair value accounting fraud, it is important to:

- Understand why and how financial statement fraud of any type is perpetrated
- Understand what is meant by fair value accounting and its broad applications in today's world
- Understand some of the core concepts associated with fair value accounting, including a basic understanding of the various methodologies used in determining fair value of an asset or liability

That is the purpose of Part I. It is only with this level of understanding that the fair value accounting issues and fraud risks explained in Parts II through IV will be fully understood.

CHAPTER 1

Overview of Financial Statement Fraud and Fair Value Accounting

Introduction to Financial Reporting Fraud

Anyone who has read a newspaper or watched the evening news in recent years is well aware that fraudulent financial reporting by big businesses has reached alarming levels. Equally startling is the frequency of fraudulent financial reporting by small businesses—as many bankers and government agencies will confirm—and even by non–business entities such as not-for-profit organizations.

In its *2008 Report to the Nation on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) identifies fraudulent reporting as one of the three categories of fraud (the other two being asset misappropriations and corruption) that collectively are estimated to cost almost $1 trillion per year in the United States. And financial statement fraud is certainly not limited to the United States.

Of the three categories of fraud tracked by the ACFE, fraudulent statements were the least common, occurring in just 10 percent of the cases studied. But when fraud occurs in that way, it packs quite a wallop. The median loss caused in the fraudulent statement schemes included in the 2008 study was $2 million. To put that in perspective, the median loss caused by asset misappropriation frauds included in the study was *only* $150,000, while the median loss caused by corruption schemes was $375,000.

Fraudulent financial reporting can be accomplished in many different ways. These methods can be classified into schemes that accomplish one or more of the following seven deceptions:

1. Inflating assets
2. Understating liabilities
3. Inflating revenues

4. Understating expenses
5. Creating timing differences (i.e., over multiple reporting periods, the total reported earnings are correct, but one period is overstated and another period is understated, such as by recognizing revenue prematurely—a form of borrowing from the future to make today look better)
6. Misclassifying balance sheet items (usually either noncurrent assets misclassified as current or current liabilities misclassified as long-term, in order to improve current ratios and other ratios)
7. Committing disclosure frauds (omitting key footnote disclosures in financial statements or misstating facts in disclosures)

In many cases, more than one of the preceding acts occurs. For example, overstatement of revenue often coincides with overstatement of assets, but it can also arise in connection with understating liabilities.

In addition, overstating or understating various elements of the financial statements can be done in several manners. In some cases, an asset or liability is properly identified and appears in the financial statements, but its amount is over- or understated. In other cases, an entire asset or source of revenue is fabricated. It is completely fictitious, not merely overstated. Other times, a liability that should be reported is omitted entirely.

This book is designed to address financial reporting frauds effectuated through the intentional misuse of fair value accounting standards. All seven of the categories of fraudulent financial reporting are affected by fair value accounting. The goal of this book is to explain how fair value accounting rules can be improperly applied to fraudulently present the financial condition or results of operations of an entity.

What Makes It Fraud?

The preparation of inaccurate or incomplete financial statements is nothing new. It has been going on for as long as there have been financial statements. But preparing misleading financial statements is not a fraud that is easily challenged. To have a strong legal case charging financial statement fraud, it must be demonstrated that the accounting standards with which those statements claim to conform are actually being violated and that such noncompliance is willful on the part of the preparers of the statements.

As a result, in order to determine whether fraud has occurred, it is essential to have a solid understanding of the accounting concepts involved in preparing financial statements.

Take a look at the report of the independent certified public accountant or auditor that accompanies any audited set of financial statements.