Financial Warnings

Management Fraud

"More Than Just Aggressive Accounting"

Assessing the Risk of Fraud

Financial Warnings Checklist

The Auditor's Role in Fraud Detection

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Assessing the Risk of Management Fraud

As noted, accounting guidelines offer managements considerable latitude in measuring the timing and amount of revenues and expenses.

Some actions might be viewed as aggressive, but within the confines of generally accepted accounting principles.

- Aggressive income recognition is not necessarily fictitious or fraudulent.

- Though the line between aggressive and fraudulent recognition is only a matter of degree.

- What may seem to be simply aggressive at the time may, in hindsight, be attributed a fraudulent intent.

- It is the intent to deceive and cover-up actions that separates legal, aggressive actions from illegal, fraudulent ones.

    - Auditors give their approval to aggressive actions

    - They have no knowledge of fraudulent ones

        - Successful court cases against them maintain either that they should have known about the fraud and were grossly negligent for not uncovering it, or worse, that they did know about the fraud and by implication, participated in it.

Management fraud consists of two different, though related actions.

- Fictitious financial reporting
    - Knowingly misstating financial results with an intent to mislead financial statement readers
- Asset defalcations
    - Illegally securing company assets for personal use (e.g., embezzlement)

Research literature refers to both fictitious financial reporting and asset defalcations as "accounting irregularities".

The term management fraud is typically reserved for the first item only, fictitious financial reporting.

However, because both actions lay the groundwork for earnings surprises, that is, future unexpected expenses and losses, they are combined here and given the more common, more encompassing collective title, management fraud.

Earnings surprises arising from management fraud (fictitious reporting and asset defalcations):

- Losses arising from writedowns of overstated assets or writeoffs of missing assets
- Losses arising from accruals of understated liabilities

A Survey of Audit Partners
Tell Us About Your Experiences with Management Fraud

From a study by Loebbecke, Eining and Willingham

Firm:	KMG Peat Marwick
Surveyed:	277 partners
Experienced fraud:	165 partners
Responded to questions:	121 partners
Experience:	20 years
No. audits with fraud:	354
% audits with fraud:	1.3%

Some of their findings follow:

Management Fraud by Industry

Industry	% of Total Frauds Noted
Banking	19.0%
Manufacturing	14.1%
Merchandising	12.5%
Savings & Loan	12.2%
Education	9.5%
Financial Services	7.1%
High Technology	6.2%
Transportation	4.7%
Real Estate	3.9%
Energy	3.6%
Health Care	2.7%
Insurance	2.7%
Agribusiness	1.5%
Printing	.3%
Total	100.0%

Management Fraud by Deceptive Action

Action	% of Total Frauds Noted
Assets overvalued	26.9%
Revenue recognized improperly	11.7%
Specious accounting judgments	9.5%
Transactions/events not recorded	19.6%
Transactions recorded in wrong period	6.1%
Expenses recorded incorrectly	13.8%
Disclosures omitted or misleading	7.6%
Liabilities understated	.1%
Misappropriation of funds	3.2%
Falsified records	1.5%
Total	100.0%

Level of Client Personnel Involved in Fraud

Management Level	% of Total Frauds Noted
Directors	7.4%
CEO	27.1%
CFO	24.9%
Other Top Management	16.3%
Middle Management	15.1%
Below Middle Management	9.2%
Total	100.0%

Financial Warnings Checklist

There are three factors that are typically present in the commission of a management fraud. These factors and indicators of the presence of each follow:

1. Conducive conditions - conditions are such that a material fraud could be committed

   Indicators of conducive conditions:

   - Operating and financial decisions are dominated by a single person or a few persons who act in concert
   - A single transaction or a few transactions have been entered into that have a material effect on the financial statements
   - The company has entered into a significant transaction with related parties
   - The company has a weak control environment
   - There are accounts that are material to the financial statements for which extensive judgment is involved in determining their balances
   - Management turnover is high
   - Organization is decentralized without adequate monitoring
   - The company has significant assets that are open to misappropriation
   - Auditor is new with little prior audit history

1. Conducive conditions (cont'd)

- The company is in a period of rapid growth
- The company has inexperienced management
- A conflict of interest exists within the company or its personnel
- The company is involved in a purchase or sale transaction with another company
- An officer of the company is a former member of the audit firm

2. Motivation - person in authority has a reason to commit the fraud

Indicators of motivation to commit fraud:

- The company's industry is declining with many business failures
- The rate of change in the company's industry is rapid
- Profitability relative to the industry is inadequate or inconsistent
- Operating results are highly sensitive to economic factors
- The company is having solvency problems
- Compensation arrangements are based on recorded performance
- Management placed undue emphasis on meeting earnings projections
- The company is in a period of rapid growth
- There exists a struggle for control of the company
- The company is confronted with adverse legal circumstances
- The company is subject to significant contractual commitments
- The company is involved in a purchase or sale transaction with another company

2. Motivation (cont'd)

- The company is highly leveraged
- Company holdings represent a significant portion of management's personal wealth
- The company has a plan to raise new capital
- Management personnel perceive their job is threatened by poor performance
- There is undue concern with the need to maintain or improve the reputation/image of the company
- Management displays a propensity to take undue risks
- Management personnel engage in an inappropriate lifestyle

3. Attitude - person or persons in authority have an attitude or set of ethical values that would permit them to commit fraud

Indicators of attitude to commit fraud:

- Management's reputation in the business community is poor
- Management has shown a propensity to be dishonest in the past
- There have been instances of irregularities in the past
- Management displays an overly aggressive attitude toward financial reporting
- Management has engaged in frequent disputes with its auditors
- Management personnel engage in an inappropriate lifestyle
- Management is considered to be highly unreasonable
- Management displays a significant lack of moral fiber
- Management displays significant disrespect for authority and regulatory bodies
- Management personnel exhibit strong personality anomalies

The authors emphasize that it is unusual for a fraud to be committed in the absence of one or more of the three fraud conducive factors:

1. Conducive conditions

2. Motivation

3. Attitude

The number of indicators for each factor that must be observed to conclude that a factor is present and influencing behavior is not known.

It is clearly a judgment call. The more indicators that are present, the higher the likelihood that a particular factor is present.

Motivation

A Closer Look at the Incentives to Take an Aggressive Stance or Commit Fraud

Incentives include:

- Higher management compensation - bonuses tied to reported earnings

- Higher share price

    - For management - increased market value of ownership stakes in company shares and options

    - For company - higher share price, reduced cost of equity capital

- More slack in debt covenants - higher net income, retained earnings, equity and working capital

- Lower apparent firm risk - reduced cost of debt capital

Class Exercise
Elite Tennis, Inc.

Elite Tennis, Inc. is a retailing operation that has recently begun expanding its franchise operations. Excerpts from disclosures provided in the company's public filings with the Securities and Exchange Commission are provided below.

Required:

Use the Early Warnings Checklist to identify present conditions, if any, that suggest to you the existence of conducive conditions, motivation, and/or attitude that might call for an auditor to expand his or her audit program.

Income Statement excerpts:

	2017	2016	2015
Revenues	$ 7,295,000	$6,243,000	$5,427,000
Total operating expenses	6,900,000	6,095,000	6,021,000
Operating profit (loss)	$ 395,000	$ 148,000	$ (594,000)

Elite Tennis, Inc. (cont'd)

Name of Individual	Capacities in Which Served	Cash Compensation
William Boland	Chairman of the Board President, Treasurer, Secretary and Director	$ 100,000
Ronald Boland	Director	$ 80,000
Kim Stations	Chief Financial Officer	$ 24,000

Name of Beneficial Owner	Amount of Beneficial Ownership	Percent of Class
William Boland	3,134,209	53.7%
Ronald Boland	671,345	12.3%
John Boland	671,345	12.3%

Elite Tennis, Inc. (cont'd)

Mr. Boland owns an affiliated store of the Company. Until October 1, 2015, this store was a franchise of the Company. Mr. Boland paid an initial franchise fee, and paid all other fees required of franchisees until July 1, 2015. During 2015, Mr. Boland paid $62,000 in franchise royalties under his franchise agreement. His store did not make any significant purchases of products from the Company until the last quarter of 2015 when his store purchased approximately $118,000 of merchandise from the Company. During 2017 and 2016, such purchases totaled $685,000 and $537,000. Effective July 1, 2017, Mr. Boland's franchise agreement with the Company was amended to eliminate the requirement that he pay a continuing royalty fee on product sales. This was done in exchange for a release of any territorial rights he may have had in connection with the opening of the Company-owned store in Las Vegas, Nevada.

Effective October 1, 2017, the franchise agreement with Mr. Boland was mutually terminated, and a new agreement was entered into with him pursuant to which he is permitted to operate an Elite Tennis store in Tulsa, Oklahoma (the Affiliate Store). The agreement also provides that Mr. Boland may purchase Company brands merchandise for the Affiliated Store at the same cost as the Company, use the facilities and personnel of the Company on a limited basis, and operate a limited mail order business from the Affiliate Store. In exchange for these rights, Mr. Boland pays the Company a fee of $3,000 per month.

In August and September 2017, the Company purchased $1,500,000 in merchandise from Mr. Boland for a promissory note for $1,100,000 and other consideration, and began purchasing inventory directly from suppliers. The promissory note bears interest at the prime rate plus 1.5% per annum, and was payable interest only on a monthly basis until May 1, 2016, at which time the Company was required to pay $60,000 in monthly principal payments, plus interest, through November 1, 2017. As of December 31, 2017, all amounts due under this note have been paid.

The Company and the Affiliated Store also share advertising costs in the Tulsa market area on an equal basis. During 2017, 2016, and 2015, the Company paid $61,000, $68,000 and $53,000, respectively, for advertising shared with the Affiliated Store, which represented one-half of the costs of such advertising.

Elite Tennis, Inc. (cont'd)

In October, 2017, the Board of Directors granted an incentive stock option to Ronald Boland to purchase 120,000 shares at an exercise price of $1.52 per share, and a non-qualified stock option to John Boland, a consultant to the Company, to purchase 120,000 shares at $1.38 per share. These options are fully vested and expire on October 20, 2022.

In October, 2017, the Board of Directors established 512,799 shares of Series A Convertible Preferred Stock and issued such shares to William Boland in exchange for services valued at $5,128. These shares were issued to Mr. Boland to replace shares which he previously relinquished in order to facilitate a proposed public offering in early 2016. Each share of the Series A Convertible Preferred Stock is convertible into one share of Common Stock in the event that the Company has annual income before taxes of at least $1,000,000 for any fiscal year.

During the year ended December 31, 2017 two persons who are officers, Directors or beneficial owners of 10% or greater of the Company's Common Stock failed to file a report on a timely basis under Section 16(a) of the Securities Exchange Act of 1934. William Boland, Chairman of the Board, Secretary, Treasurer and a Director of the Company, failed to file a Form 4 Statement of Changes in Beneficial Ownership reporting the acquisition of Series A convertible preferred Stock in October, 2017. William Boland reported this information in an amendment to Form 5 Annual Statement of Changes in Beneficial Ownership for 2017, which amendment was filed in March, 2018. Ronald Boland, President and a Director of the Company, failed to file a Form 4 Statement of Changes in Beneficial Ownership reporting the receipt of an incentive stock option in October, 2017. Ronald Boland reported this information in an amendment to his Form 5 Annual Statement of Changes in Beneficial Ownership for 2017, which amendment was filed in March, 2018.