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Why CFOs Commit Accounting Fraud

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OVERVIEW

We investigate the reasons behind the occurrence of accounting fraud despite the enactment of internal control regulation both in the U.S. and in Japan. Using a case study approach to identify the causes of accounting fraud, we present a preventive solution for managers. Chief financial officers (CFOs) of firms bear the responsibility of pointing out problems they detect through the exclusive information they are privy to regarding the firm. Ultimately, CFOs need to make a difficult decision to avoid losses as a manager. To this end, CFOs have two options: to commit aggressive earnings management or to launch layoffs. In the event a firm makes losses, the CFO is responsible for counteractions such as layoffs and business restructuring. Generally accepted accounting principles allow managers to manage earnings; however, accounting numbers sometimes depend on CFOs’ discretion. Therefore, CFOs opt for earnings management as a pre-emptive measure to losses and related consequences, and aggressive earnings management is found to be a major cause of accounting fraud.

1. Introduction

In Japan during the 1970s, finance and accounting were unpopular subjects among students and the younger generations. Images of accountants and treasurers tended to portray monotonous, rigid people. Accountants were characterized as financial watchdogs with no sense of humor or flexibility, perpetually conceptualizing the worst-case scenarios. How-
ever, from the 1990s, these perceptions changed completely as shareholders matured and the position of accounting manager (Keiri-Bucho in Japanese) changed to chief financial officer (CFO), whose role is to act as a supporter and adviser to the chief executive officer (CEO). This elevation in corporate status of CFOs is the result of shareholder value management, which began in the early 1990s in Japan.

Why did Japanese management shift to shareholder value management? The first reason was the decline in corporate performance during the 1990s, which led firms to seek improvement in their financial situation in response to pressure from financial markets. The second reason was the impact of sluggish share prices in the 1990s, which left emerging institutional investors dissatisfied. The third reason was that institutional investors in pension funds and trust funds developed their influence in capital markets. Consequently, shareholder value management became the dominant management style among Japanese firms.

Shareholder value management places more importance on the interests of the shareholders’ over those of other stakeholders, such as customers, managers, employees, societies and other interested parties. This management style aims to maximize shareholder value. According to financial theory, firms can achieve this by raising its share price or increasing free cash flow. However, it is quite difficult for a firm to raise the share price since this is determined by capital markets. Moreover, no market exists for shares in private and unlisted firms. Therefore, maximizing free cash flow has become the most important focus for firms. Shareholder value is calculated by the present value of future cash flows. If a firm increases its free cash flow, then it may also increase shareholder value. Of course, the most important source of free cash flow is profit.

Generally, firm earnings improve by increasing revenues and/or decreasing expenses. However, earnings are also improved by various accounting practices, such as inventory valuation adjustment, various kinds of allowances or provisions, deferred tax accounting, market value accounting, and tax avoidance schemes. CFOs usually manage all these accounting practices, which raises their status within the firm. This also means that only the CFO can improve the firm's cash flow. This elevated status of CFOs under shareholder value management began in the U.S. in the early 1980s and spread to Japan in the 1990s. Since then, CFOs have become deeply involved in the decision-making process, with a focus on cash flow, shareholder gain, and short-term earnings.
2. Enron Fraud Orchestrated by the CFO

A classic example of fraudulent accounting practices under shareholder value management was the scandal surrounding American energy company Enron. As CFO, Andrew Fastow was a key financial strategist for the firm. He earned his MBA at Northwestern University and worked for Continental Illinois National Bank and Trust Company in Chicago. He was appointed to his position by Enron’s CEO, Jeffrey Skilling. Importantly, Fastow set up many special purpose entities (SPEs) for Enron’s various business operations.

Fastow made full use of a range of financial strategies beginning with the strategy of a mark-to-market (MTM) accounting system. When long-term supply contracts were agreed, revenues were reported at present value. From the viewpoint of Japanese and international accounting rules, this was an illegal procedure. However, under the U.S. accounting rule at that time, it was legal, and other large energy and power industries also adopted these accounting procedures. The second strategy was adopting typical cash flow maximization by reducing bank debt to raise the firm’s rating. The third strategy was the asset-light strategy, which created greater liquidity in assets. To achieve the asset-light strategy, the CFO established various SPE arrangements that were invested by Enron shares. Therefore, the strategy was dependent on the rise in Enron’s share price.

Financial markets required Enron’s top management to report quarterly results to raise the share price. Over the course of the 1980s and 1990s, various factors influenced this focus on quarterly results. Because of the 401 (k) retirement plan, more Americans expected quarterly earnings. Therefore, more firms gave their executives stock options. Financial markets also expected growth in earnings.

The Enron scandal erupted essentially because of the company’s ambitious and uncompromising strategies: "Enron’s corporate culture was essentially focused on two things: the first was profits and the second was how to make even greater profit. The firm didn’t strive to create long-lasting business relationships and had little desire to be involved in anything that smacked of the low-margins associated with retail-oriented business.”

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1. Peter C. Fusaro & Ross M. Miller. (2002). What Went Wrong at ENRON, WILEY, pp. 47
3. Internal Control is Not Effective in Preventing Corporate Fraud

After the Enron and WorldCom scandals, the Sarbanes-Oxley Act (SOX)—enacted by the U.S. Public Company Accounting Reform and Investor Protection Act of 2002—imposed new rules on corporate executives, including CEOs and CFOs.

In Japan, SEIBU railway was accused of material misstatement in their annual report for October 2004, while accounting fraud at KANEBO was revealed in 2005. Following these exposures, the Financial Instruments and Exchange Act in 2006 legislated the implementation of internal control systems. Listed firms in Japan were subject to the Act from FY 2008. However, the Act has not been effective in preventing corporate fraud, and many scandals have continued to be revealed in the U.S. and Japan. In 2003, FreddieMac, a major mortgage firm, misstated $5 billion in earnings. American International Group was accused of a massive accounting fraud totaling $3.9 billion, along with bid-rigging and stock-price manipulation. Lehman Brothers disguised $50 billion in loans as sales. Under this situation, the U.S. Securities Exchange Commission (SEC) is now strengthening the SOX and financial regulations especially to prevent financial fraud.

In Japan, Olympus was involved in accounting fraud that involved covering up $687 million in losses. In addition, Daio Paper gave $100 million in illegal loans to one of its founding families. In 2015, Toshiba’s accounting scandals were revealed by a whistleblower: the company’s combined operating profit for the five-year period ending in March 2014 was likely inflated by over ¥150 billion.

4. Earnings Management May Lead to Accounting Fraud

Accounting fraud is an old problem, which sometimes makes it difficult to ascertain whether a particular accounting practice is legal or illegal. "Earnings management within Generally Accepted Accounting Principle (GAAP) allows managers to use a variety of accounting techniques to produce financial reports that may paint an overly positive picture of a firm’s business activities and financial position. Earnings management takes advantage of how accounting standards can be applied and are legitimately flexible when firms can incur expenses and recognize revenue. It can be difficult for outside users to differentiate these sanctioned practices from earnings manipulation. Although managers are allowed to practice
earnings management within GAAP theoretically, this is often leads to manipulation or earnings fraud.”

A firm can change its on-paper profitability using an earnings management. If a firm makes a huge loss, then it may face various problems. A firm always experiences pressure from financial markets. Many shareholders may intend to sell their shares to avoid the capital loss, and, as a result, the main shareholders may require structural reforms, including layoffs, mergers, and acquisitions. Banks may stop financing the firm. Suppliers may not sell their merchandises or materials to the firm on credit because of the risk of its insolvency. Customers may not buy the products of the firm given the risk of service loss. Therefore, CFOs are obliged to show a profit to the full legal extent. Once a firm makes a loss, the management has to take actions, such as layoffs and business restructuring. These are very tough decisions, which is why CFOs opt for earnings management.

Essentially, there are many ambiguities in accounting regarding the recognition of revenues and expenses, and it is difficult to differentiate earnings management from earnings fraud or manipulation. Therefore, the CFO has the ultimate responsibility of showing a profit—this is the firm’s primary concern and a natural part of management behavior. To report a loss would be unacceptable since it would require countermeasures from stakeholders, such as shareholders, banks, suppliers, and the parent company. The firm’s management has to prepare and explain the reported losses and their restructuring plan to the stakeholders and then implement that plan.

The CFO has to analyze the causes behind the loss and explain them to the stakeholders. If a firm reports a loss, then banks are reluctant to lend money; thus, in the worst-case scenario, it will face a shortage of working capital and go bankrupt. Therefore, CFOs make every endeavor to fulfill banks’ and other stakeholders’ requests as quickly as possible.

The CFO not only describes the difficult conditions faced by the firm but also presents plans for a profitable operation with new products and businesses. The development of new products requires new human resources, whereas employees in the unprofitable business are reduced. The management executes layoffs and structural reforms and, at the same time, hires new employees and invests in new businesses. This is a demanding job, but

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the CFO is responsible for devising solutions.

There are alternatives, such as waiting for a market recovery or introducing new profitable products before executing layoffs and implementing structural reforms. Although nobody wants to close factories and sales offices or cut jobs, it is unacceptable for the management to be making a loss. If the firm makes even a small profit or breaks even, then it is not necessary to execute layoffs and structural reforms unless an unexpected crisis occurs, such as the Lehman Brothers’ collapse.

The CFO is often the key to the firm’s performance. The CFO must question whether the financial report is prepared in accordance with GAAP, i.e., the report must be accurate, reasonable, audited, and complete. This is a very difficult question and a headache for CFOs because there are many accounting procedures and rules, business practices, and risks between countries that need to be considered. Especially, there are huge differences in provisions or allowances, calculation methods for depreciation, and evaluation methods for inventories or securities; as a result, these estimations significantly impact the earnings statement. If the CFO decides that the operations have low or no risk, then the firm may reduce the provision or allowance as much as possible and, as a result, turn a loss-bearing firm into profit-generating one; thus, the difference between profitable and unprofitable firms rests in the opinions and perspectives of the CFO. If the CFO considers that a profit can be shown using earnings management, then they may wait for a year or more; in this way, the loss is postponed in the expectation of realizing future profits.

5. Case Study

5.1 Example of a Trading Company

In 1990, a trading company accumulated huge inventories due to decreasing sales, which would normally be written down. If the CFO were to write down the inventories, then the firm would report a huge loss for that fiscal year. If the CFO were to report this loss, then banks would be reluctant to finance to the firm. The CFO of the trading company decided not to write down the inventories and postponed the loss. He explained to the auditors that the industrial products market would recover and register sufficient growth and that it was possible to sell out all inventories at the same price, thereby eliminating the need
to write down the stock.

Unfortunately, the industrial market did not recover in 1991, and the firm would definitely make a huge loss that year if it disposed of inventories at discounted prices. If the CFO were to write down the inventories, report a loss in the previous year, and, as a result, submit to restructuring, then the firm would be able to avoid the loss in 1991. However, the CFO repeated their previous strategy, i.e., he opted for the “double down” strategy. In the second half of 1991, the new automotive parts business that the firm had been developing for a long time began to expand rapidly, which covered the loss of the industrial products and generated a profit in 1991.

The industrial market recovered in 1992, and the firm successfully wrestled market share from competitors that had reduced their sales force and channels by restructuring in 1990 when the trading company had preserved theirs. As things turned out, the CFO’s strategy to not report a loss and execute restructuring in 1990 proved to be an astute one. This is a good example of a CFO not reporting a loss to continue the business successfully.

**5.2 Example of a Consumer Product Manufacturing Company**

Once a firm makes a loss, the management establishes reserves for a loss on business restructuring and reports a huge loss in the current term to overcome difficult legacies from the past. Using the restructuring reserves, the management develops a new business and sells out the unprofitable operations and non-performing assets. These procedures are common in practice. The CFO estimates the restructuring cost and records the reserves as much as possible. The restructuring reserves include the accrued expenses to cover future costs of layoffs or of closing down a section of a business or a plant.

In 1995, a consumer product manufacturing company announced a restructuring plan to reduce its unprofitable consumer products and expand its new business in computer peripherals. The sales offices were integrated or partly closed. As a result, the number of sales offices decreased from ten to 6, and the firm reduced its workforce by 50 percent.

The firm explained the structural reforms as innovative transformation from an unprofitable consumer electronics business to a new, profitable computer business. Finally, the firm laid off more than 1,000 employees and incurred expenses of $120 million over two years.
However, although the firm reduced employee numbers and unprofitable products and expended a considerable amount of money, it reported a loss in 1996 due to delays in its new product development. The CFO could not report a loss in 1996 because he had already expended $60 million the previous year and promised to recover the loss. He decided to use the remaining restructuring reserves ($60 million) to compensate the loss and did not report the loss in 1996. This meant that he would postpone restructuring for the next year but would have no reserve capital. However, he avoided reporting a loss in 1996 and maintained employment and a sales force.

In 1997, the new computer peripherals business could not generate a profit because of market-price decline. The CFO was distressed by the drop in the firm’s performance. He had already used the restructuring reserves for generating a profit in 1996, and he had no reserves for the structural reform. However, if the firm reported a loss again in 1997, then banks would stop financing and the firm would run short of money.

The CFO sought a simple solution to generate a profit and avoid a loss in 1997 using various accounting techniques. The firm could adjust its financial statements by overstating its revenues or assets, postponing expenses, and under-recording liabilities. If the firm could implement its new products, then it would make a profit and these adjustments and postponement would be corrected by the profitable operation. Thus, the CFO reported a profit in 1997 at the expense of the next year’s income.

However, the results were devastating. In 1998, the sales of the new products remained stagnant and the firm reported a huge loss. The CFO had no countermeasures to the difficult situation. Although he had made efforts to maintain the business, he was criticized for accounting fraud and he lost his position as CFO.

6. Conclusion

Given their knowledge of firm finances, CFOs are responsible for pointing out profitability problems to the management. Only the CFO can control an aggressive and positive CEO; however, the CFO must make difficult decisions on whether to utilize earnings management and commit accounting fraud or to launch layoffs and restructuring. Accounting is not a rigid or absolute practice; in the case of CFOs, firm profit and loss are at the discretion of their decision making and underlying rationale. Firms that commit accounting fraud go
bankrupt and are relegated in the capitalist economy hierarchy. The prevention of accounting fraud depends on the conscientiousness and sense of duty of the CFO and the CEO. This situation also signals the limitations of corporate governance.

However, to help prevent accounting fraud, regulators, auditors, and the management should consider the following two countermeasures.

First, the stock exchanges should directly hire and pay auditors.

"Essentially, the responsibility for hiring and paying auditors needs to be moved from company managers to the stock exchanges. . . . As a result, stock exchanges would have a strong incentive to ensure that listed companies provide high quality information to investors - which is precisely why they require listed companies to prepare audited financial reports. . . . The stock exchanges could cover the audit fees and their oversight expenses. . . . In 2002, audit fees for NYSE firms totaled roughly $7 billion. . . . the total trading volume on the exchange was 360 billion shares, or $10 trillion. That means the audit fees could have been funded by an incremental trading fee paid to the stock exchange of less than two cents per share traded, or through a 0.07 percent fee on the dollar value of shares traded."

Second, the CEO should focus on long-term management and refrain from disclosing short-term results and/or forecasts.

Maximizing profits is the most important goal for a firm. When a CFO discloses the firm’s short-term results and/or forecast, this influences its share price and rating. Therefore, to maximize short-term earnings, CFOs tend to increase quarterly results using a legally permitted financial technique called "earnings management." However, earnings management may lead to accounting fraud. To avoid accounting fraud, a firm should focus on long-term management. Only a long-term and forward-looking management style will allow CFOs to prepare accurate and transparent financial statements.

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