ACCOUNTING

The language of the business world

ACC 1701X
Accounting for Decision Makers

Lecturer: Dr. Hanny Kusnadi

Prior Lecture Refresher

- Adjusted Trial balance
  - Post adjusting journal entries to get Trial Balance
- Preparing Financial Statements using Adjusted Trial Balance
  - Income Statement
  - Statement of Changes in Equity
  - Statement of Financial Position
- Closing the Books
  - Close out temporary accounts (revenues, expenses & dividends) to retained earnings
- Financial ratio: Profit Margin

Chapter 5

Internal Controls
& Financial Statements Integrity

Goals for Lecture 05

Internal Controls & FS Integrity

- Potential Problems in Financial Statements (LO1)
- What is Fraud?
- Safeguards to Minimize Problems (LO2)
  - Principles of Internal Controls
- Role of Auditors (LO5)
- Earnings Management (LO3)
- *Accounting Scandals (Not Examinable)*

We will not cover the following topics in this module:

- *Sarbanes-Oxley Act (SOX) (LO4)*
- *SEC (LO6)*

Potential Problems in Financial Statements

(1) Errors - unintentional mistakes, which are corrected when detected.

- Not entering a transaction into the system – e.g. an invoice from a supplier was lost
- Entering the wrong amount/information into the system – e.g. an invoice for $500 was incorrectly entered as $5,000
- Entering wrong accounts– e.g. debiting the wrong expense account

(2) Disagreements on judgement

- Accounting involves judgement and estimates, so different parties can reach different conclusions based on the same facts!
- For example: Determining the amount of revenue “earned” during the period for project spanning multiple periods.

(3) Frauds - Intentional errors in order to manipulate financial statements

Errors Effects - Company PopIt
Example #1

Example #1: Company PopIt paid its 2022 rent in advance in 2021, but mistakenly recorded it all as Rent Expense in 2021 .

What is the effect of this error on its:

(a) 2021 Net Income?

(b) 2022 Net Income?

(c) 2021 Statement of Financial Position?

(d) 2022 Statement of Financial Position?

Errors Effects - Company PopIt
Example #2 & 3

Example #2: Company PopIt mistakenly recorded payment of an accounts payable twice.

What is the effect of this error on its SFP and NI?

Example #3: Company PopIt mistakenly recorded purchase of $1,600 PPE for cash by debiting Misc. Expense and crediting cash.

What journal entry should it record to correct the error?

What is Fraud?

Fraud is generally defined as an attempt to deceive others for personal gain.

Corruption

Misusing one's position for inappropriate personal gain.

Theft (embezzlement) of company resources

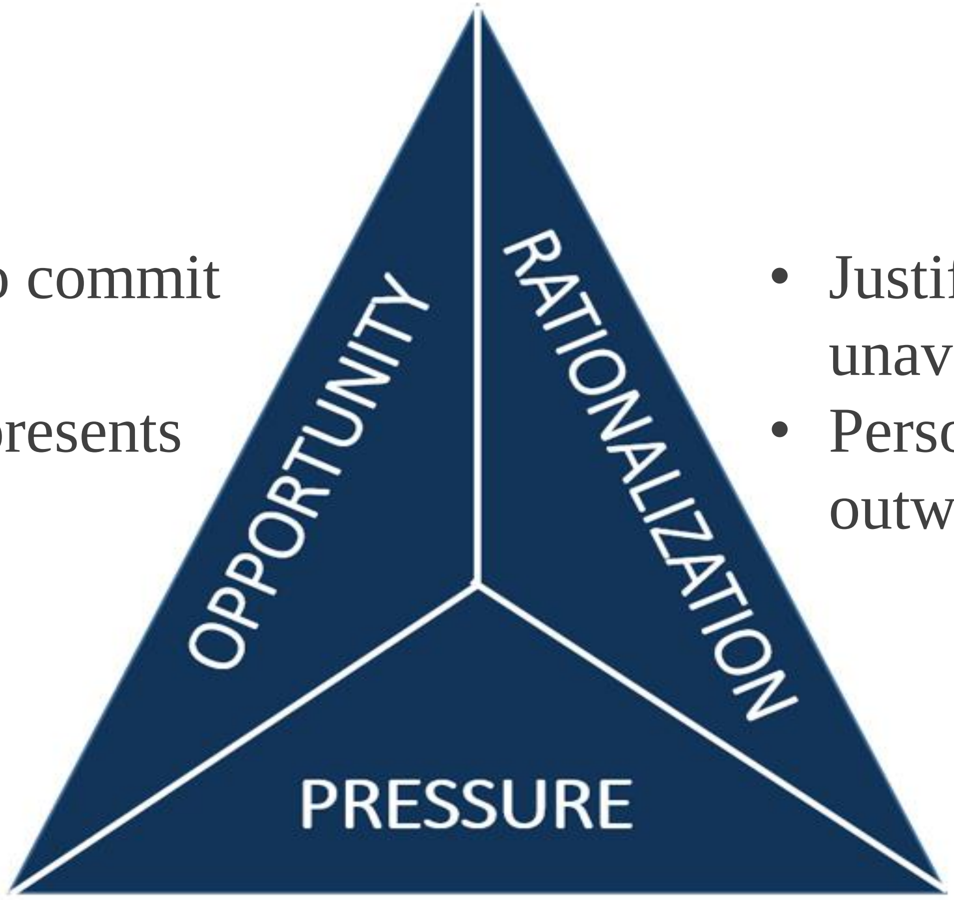
Asset Misappropriation

Financial Statement Fraud

Misreporting amounts in the financial statements to portray more favorable financial results.

The Fraud Triangle

- Employee has means to commit the fraud
- Weak internal control presents opportunities



- Justification of action as unavoidable/necessary.
- Personal feeling of entitlement outweighs moral principles

- Pressure to meet financial, personal, societal goals/expectations
- eg. loan covenants, maintain stock price, attract investors

Internal Control System

Internal control refers to policies and procedures designed to:

- Ensures reliable and accurate financial records
- Properly account for and safeguard assets
- Promotes efficient operations
- Ensure adherence to company policies
- Urge compliance with laws and regulation

Internal Control Structure

Five Basic Categories of Internal Control Structure

- The control environment – corporate culture & top management's attitude towards internal control
  - Clear organizational structure establishes clear lines of authority & responsibility
- Monitoring
  - Independent oversight of management – through board of directors (BOD) & internal and external auditors
- Risk Assessment – *typically covered in auditing course*
- Information and communication – *typically covered in auditing course*
- Control activities – policies and procedures used by management to meet their objective.

Control Activities: Principles of Internal Control

<u>Preventive Controls:</u>

(1) Establish responsibilities and segregate duties

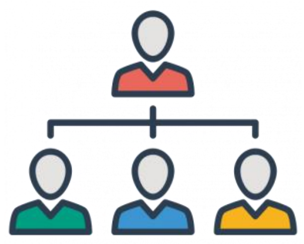
- Do not make one party/department responsible for all/conflicting parts of the process
- Eg. Employee in charge of purchasing from supplier do not approve payments.

(2) Proper procedures for authorization

- Different levels of authority – e.g. Setting authorizing limits on certain transactions

(3) Control assets and records: separate recordkeeping from custody of assets.

- A person who controls or has access to an asset must not keep that asset's accounting records.
- Eg. Warehouse manager controlling inventory should not have access to the inventory accounting records



Principles of Internal Control

Detective Controls:

(4) Maintain adequate records.

- Good recordkeeping helps protect assets and ensures that employees use prescribed procedures.
- Eg. Paying suppliers using prenumbered checks and digitally documented electronic fund transfers.

(7) Perform regular and independent reviews.

- Check others' work. Eg. Supervisor reviews subordinate's work
- Frequent reviews of procedures to evaluate effectiveness and promote adherence
- Eg. Internal auditors not directly involved in the activities being audited gives impartial perspective and provides check
- Eg. External auditors independent of the company provides assurance of financial statements

Limitation of Internal Control

Internal controls can never completely prevent and detect errors and fraud.

Human error
or
Human fraud

- Human error: negligence, fatigue, mis-judgement, confusion, carelessness
- Human fraud: Intent to defeat internal control or collude for person gain

Costs must not exceed benefits

- Companies can only implement internal controls if the benefits outweigh the costs
- Eg. Eliminate shoplifting (benefits) by body searching every customer, but such an irritating policy would drive customers away (costs from loss of sales).

Role of Auditors: Internal Auditors

- Auditors provide management (and stockholders) with some assurance that:
  - The internal control system is functioning properly.
  - The financial statements fairly represent the financial performance of the firm.
- Internal Auditors: an independent group of experts in controls, accounting, and operations

Works of Internal Auditors
Monitor operating results and financial records
Evaluate internal controls
Assist with increasing the efficiency and effectiveness of operations
Make sure that laws and regulations are complied
Detect fraud

Role of Auditors: External Auditors

- Independent certified public accountants (CPAs) that examine an organization's financial statements to determine if they are prepared and presented in accordance with the prevailing accounting standards (e.g. IFRS, GAAP) and are free from material (significant) misstatement.
  - E.g. KPMG, EY, Deloitte, PWC
- Issue opinions about the reliability of an organization's internal controls
- Disclose key audit matters (KAMs) in the audit report – usually include areas of significant management judgement
- Note that it is not possible for auditors to guarantee that financial statements are "correct."

Can only provide **reasonable assurance** that financial statements are "presented fairly."

Real FS:
Tencent's Audit Report – Audit Opinion

OPINION

What we have audited

The consolidated financial statements of Tencent Holdings Limited (the "Company") and its subsidiaries (the "Group"), which are set out on pages 169 to 310, comprise:

- the consolidated statement of financial position as at 31 December 2021;
- the consolidated income statement for the year then ended;
- the consolidated statement of comprehensive income for the year then ended;
- the consolidated statement of changes in equity for the year then ended;
- the consolidated statement of cash flows for the year then ended; and
- the notes to the consolidated financial statements, which include significant accounting policies and other explanatory information.

Our opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2021, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards ("IFRSs") and have been properly prepared in compliance with the disclosure requirements of the Hong Kong Companies Ordinance.

- **provide reasonable assurance that financial statements are "presented fairly."**

Real FS:
Tencent's Audit Report - KAMs

KEY AUDIT MATTERS

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key audit matters identified in our audit are summarised as follows:

- Revenue recognition on provision of online games value-added services – estimates of the lifespans of virtual items
- Impairment assessments of goodwill, investments in associates and joint ventures
- Fair value measurement of financial instruments, including financial assets at fair value through profit or loss, financial assets at fair value through other comprehensive income and other financial liabilities

- Refer to Tencent's 2021 full audit report for details on the KAMs. (Available for download on Canvas)

Earnings Quality

- Recall that the objective of financial statements is to provide useful information to users.
- Financial information has to be of **high quality** to be useful.
  - Relevant
  - Reliable (free from error & fair representation)
- When the statements don't tell what really happened; instead, they tell what management wants them to tell. This is what we call "cooking" the books!
  - Using accounting gimmicks to make a company's financial results look better than they actually are!

"I am quite certain that there was absolutely no 'cooking' of the books. Reheating however..."

Earnings Management:
Why companies "cook" the books?

Firms and individuals have **<u>incentives</u>** to manage reported financial statement and manage earnings in various settings:

- To meet internal targets
  - E.g. To reach certain management bonus threshold / targets
- To meet external expectations: investors & other stakeholders (e.g. customers, suppliers, financial analysts)
  - E.g. Missing an analyst earnings forecast usually results in drop of share price
  - E.g. Companies would rather report a small profit than a small loss.
- To smooth income in order to appear less risky /cover up mistakes
  - E.g. A smooth trend of earnings is more desirable than volatile earnings
- To window dress (look good) for an IPO or a bank loan

Earnings Management & Importance of Accounting

- A prudent financial statement user should recognize those situations in which a company is under great pressure to manage earnings.
  - In such cases, the assumptions underlying the financial statement numbers should be carefully scrutinized.
  - You, as a financial statement user, need to critically consider the estimates and assumptions made by the firms in preparing its financial statements.

That's WHY knowledge of Accounting is important!!!

In-class Activity
Blossom Co

During the year-end audit, the auditors found the following errors in Blossom Co's financial statements:

a) No adjusting entry was made for salaries of $15,000 that were earned in December but will not be paid until January.

b) On November 1, Blossom Company paid an insurance payment of $12,000 for a twelve month policy. On November 1, the full $12,000 was debited to insurance expense. No adjusting entries were made to insurance expense at year end.

c) On December 15, Blossom Company received a $5,000 prepayment for services that will be performed in January. Cash was debited and service revenue was credited when the cash was received.

d) The recording of a receipt for an accounts receivable of $15,000 was recorded twice.

e) On December 20, Blossom Company borrowed $20,000 from a bank by signing a note. The transaction was inadvertently recorded as $200,000.

f) Cash was credited when depreciation expense of $35,000 was recorded.

g) The acquisition of inventory for $40,000 was inadvertently recorded to the supplies account.

Prepare the necessary journal entries to correct each error (omit explanations).
What are the effects of the errors on the FS if they are not corrected?

Supplementary General Business Knowledge

Note:

The information in the following slides are general business knowledge to broaden your horizon on accounting issues.

If time permits, I will cover them in the lecture.

They are not from the textbook and will not be examinable.

Accounting Scandals

Depending on how much time we have, we might discuss the following (but not limited to) issues:

- Ways that companies can manipulate the books
- Cash Flow Hocus Pocus
  - Interesting cases of cash flow manipulation
- Infamous Accounting Frauds Case Studies
  - Enron (2001)
  - Satyam (2009)
  - Wirecard (2020)

How do companies “cook” the books?

Common ways companies manipulate the books:

- **Manipulating revenues**
  - Improper recognition
  - Fake/fictitious revenues
  - Through improper transactions, typically with related parties
  - Channel stuffing
- **Manipulating estimates**
  - Inappropriate methodologies (eg. depreciation, write-offs)
- **Manipulating expenses**
  - Improper capitalization of expenses
- **Manipulating cash flow**
- **Manipulating weak internal controls**

To recognize or not to recognize: Cases of revenue recognition gimmicks

Xerox (2002): fined $10m by SEC

- Improperly classify short-term equipment rentals as long term leases , resulting in accelerated revenue recognition. Also stored revenue off the balance sheet in a “cookie jar” and released it strategically to boost earnings.

Nortel Networks (2007): fined $35m by SEC

- Fraudulently accelerated revenue in 2000 to meet targets. Also maintained a “cookie jar” and used it to turn 2003 loss into profit, allowing large bonuses to be paid to senior executives.

GROUPON (2011): SEC forced it to restate earnings for years 2009-2011 before IPO

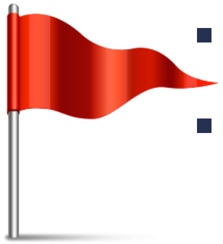
- Groupon recognizes revenue from the entire price of a deal, then report cost of goods sold for the portion it pays to the supplier. E.g. If a deal is sold for $100, even though Groupon only keeps $10 of it as commission, it reports the full $100 as its revenue, thus <u>inflating</u> its sales revenue! (And $90 as cost of sales)

Cash Flow Hocus Pocus
Interesting Cases of Cash Flow Manipulation

- Cash is tangible, so surely it cannot be manipulated?

Think again!

- **CASE 1: Netflix *(Misclassifying Inventory Purchases)***
  - When Netflix first started, its original business was in renting out DVDs to customers by mail.
  - For years, Netflix has treated its purchase of DVDs -- the essential inventory of its business -- as an <u>investing outflow</u>, rather than an operating outflow.
  - This is especially curious, because most of Netflix's new DVDs are amortized over a period of just one year.
  - Netflix's accounting treatment provides a big boost for its operating cash flows.
  - **Red Flag:** Always question large investing outflows when they appear to be part of a company's normal cost of operations.



Cash Flow Hocus Pocus
Interesting Cases of Cash Flow Manipulation

- **CASE 2: Oxford Industries *(Securitizations)***
  - Oxford Industries, an Atlanta apparel company, doubled its CFO in 2001 from the year before to $74.4 million.
  - Biggest boost to CFO came from a massive decline in Accounts Receivable.
  - Did its customers all suddenly pay up? NO!
  - Oxford actually sold $80.5 million of its receivables, or what we call “securitization” of receivables, to third parties.

  - **Red Flag**: Watch out for companies that starts or steps up securitization programs! It can create the impression that CFO that year is really better than it is.

The poster child of accounting scandal: **ENRON**

- Houston-based energy giant – 7th largest company in the U.S in 2001. Largest seller/buyer of natural gas and electricity with reported $100 billion revenues.
- Investigated in 2001 by SEC. Went bankrupt with US$74 billion in losses. All its employee retirement accounts wiped out!
- Major Perpetrators:
  - Ken Lay (Chairman/CEO) – died before sentencing in 2006.
  - Jeff Skilling (CEO) – served 12 years in federal prison, recently released in Feb 2019.
  - Andrew Fastow (CFO) – served 6 years in prison
  - Arthur Anderson (Auditors) – the accounting firm collapsed following Enron scandal.
  - Stock analysts? – who kept pushing Enron stock up

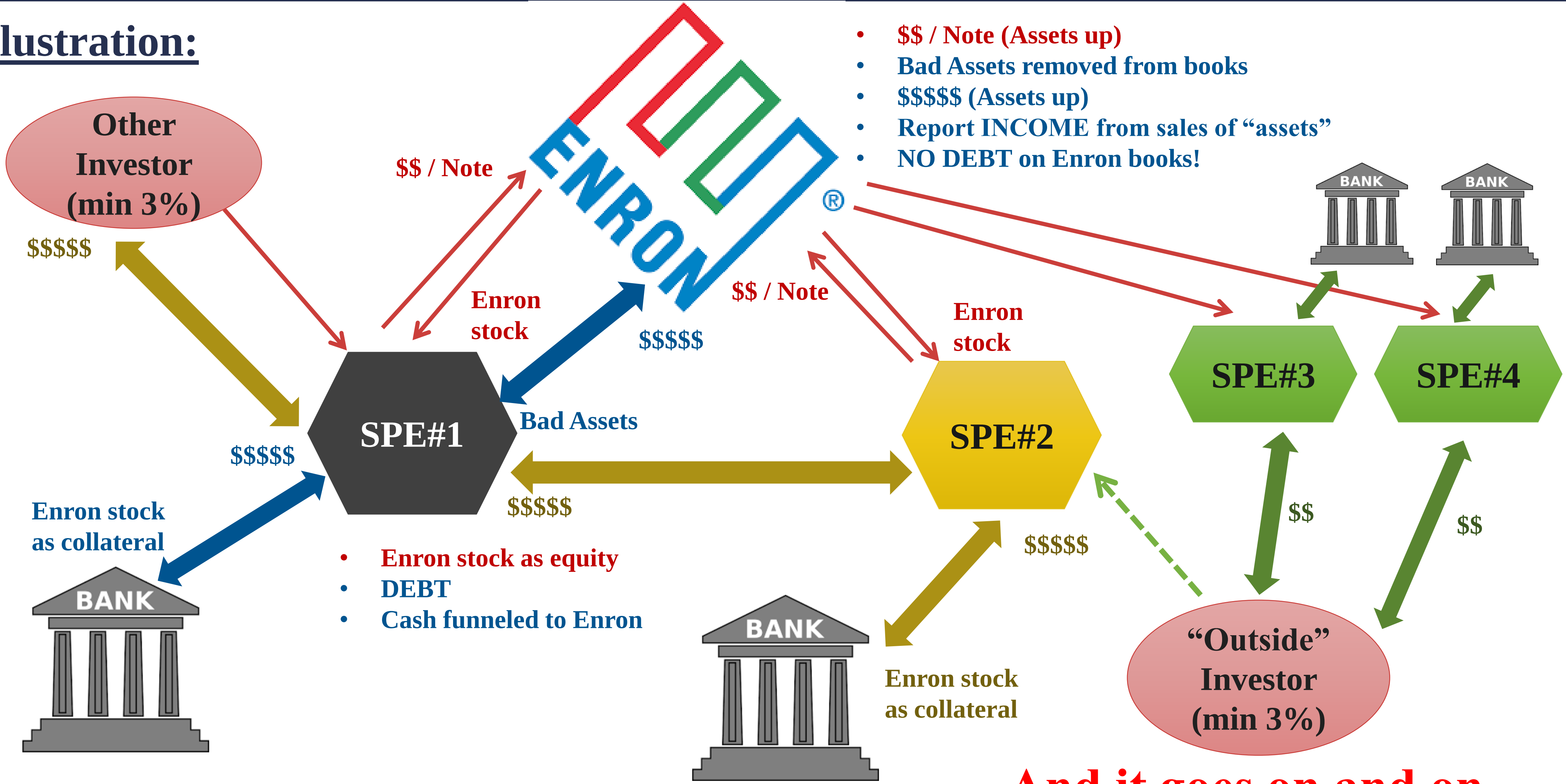
The poster child of accounting scandal: **ENRON**

Through various complex and dubious accounting schemes, Enron managed to:

- Inflate income and profit
  - Using long –term energy contracts to recognize future inflow as revenues causing massive inflation in non-existent revenues
- Hide losses and debts in off-balance sheet subsidiaries
  - Using complex SPEs (special purpose entities) to engage in fraudulent transactions and hide debts and losses from Enron’s Balance Sheet.
  - It created more than 500 SPEs and thousands of dubious partnerships.
- Inflate stock price and credit ratings (maintaining its credit rating is vital in keeping stock price high)
- Funnel funds to personal parties (themselves, family, friends)
- Fraudulently misrepresent Enron’s financial performance in public reports
- Reduce tax payments

A tangled web of lies and deceit: ENRON

SPEs Illustration:



- $$ / Note (Assets up)
- Bad Assets removed from books
- $$$$$ (Assets up)
- Report INCOME from sales of "assets"
- NO DEBT on Enron books!

- Enron stock as equity
- DEBT
- Cash funneled to Enron

And it goes on and on….

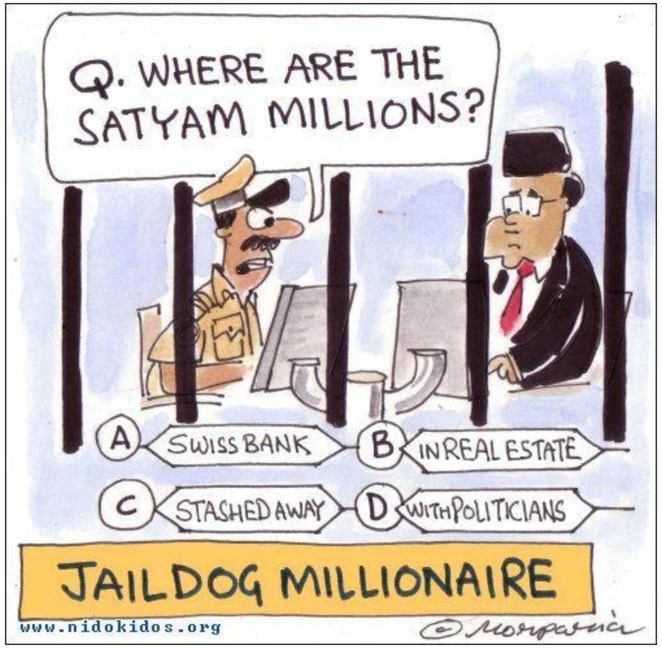
Now you see it , now you don't! Where did the $$ go? SATYAM

- Indian IT services company – World Economic Forum named it one of the 100 most pioneering tech company in 2000
- Listed in NYSE in 2001, with over 50k employees by 2008
- In Dec 2008, a botched acquisition attempt of Maytas triggered chain of events that led to Founder-Chairman Raju confessing in Jan 2009 that the company's accounts were falsified for many years.
- Major Perpetrators:
  - B. Ramalinga Raju (Founder/Chairman)
  - B. Rama Raju (Brother/ Managing Dir.)
  - V Srinivas (CFO)
  - PWC (Auditor)
  - Most of the perpetrators only got 7 years imprisonment!

Now you see it , now you don't! Where did the $$ go? SATYAM

Accounting scam of US$1.5 billion:

- Inflating revenues through false sales invoices
- Forging bank documents to show non-existent cash deposits.
- Funds funneled to Raju and his family members:
  - Family-controlled firms Maytas Properties and Maytas Infrastructures bought massive land and property
  - 356 investment companies controlled by Raju family members were allegedly used to divert funds
  - 13,000 fake non-existent employees used to embezzle funds
- In Dec 2008, Satyam tried to acquire Maytas (in an attempt to fill the gap in "fake" assets) but investors reacted negatively to the announced deal, questioned the nature of the related party transaction and its stocks plummeted.



"Largest" Fraud in European History: WIRECARD

- Founded in 1999 – German payments processing fintech
- Once hailed as the "German Paypal", it had market cap of $24 billion at its peak in 2018.
- Declared insolvency in June 2020, **owing creditors €3.5 billion.**
- Its stock price plunged from €100to €2 in matter of days!
- CEO Marcus Braum was arrested for fraud & market manipulation – he continues to deny any wrongdoings and knowledge of the fraud.
- CFO Jan Marsalek "vanished" into thin air (in his private jet) – He is now one of the most wanted men on the planet!

"Largest" Fraud in European History: WIRECARD

€4 billion Accounting Fraud

- Fraudulently inflated sales and profits.
- €1.9 billion cash "MISSING" - this is ¼ of its whole balance sheet!
- For many years, Wirecard lied to its auditors EY of large sums of money held in Singapore's OCBC – and for many years EY failed to verify the existence of funds with the Singapore bank, instead relying on "forged" documents provided by a Singapore-based trustee.
- Wirecard tried to acquire Deutsche Bank in an attempt to plug its massive fraud. (subject to a clean bill of health by special audit to be performed by KPMG)
  - During the special audit, Wirecard told KPMG that money were transferred out of OCBC to two Philippines banks. It even hired actors in Philippines to pretend as bank officials in an attempt "convince" the auditors.
  - In its April 2020 report, KPMG stated it could not verify the funds.
- In June 2020, EY refused to sign off on the annual audit stating €1.9 b cash was "spurious". One week later, WireCard collapsed and filed for insolvency!

Take Away for Lecture 05

- Potential Problems in Financial Statements
  - Unintentional errors
  - Disagreements in judgements & estimates
  - FRAUD
- Principles of Internal Controls
- Role of Auditors : Internal & External
- Earnings Management & Earnings Quality
- Accounting Scandals (Not Examinable)

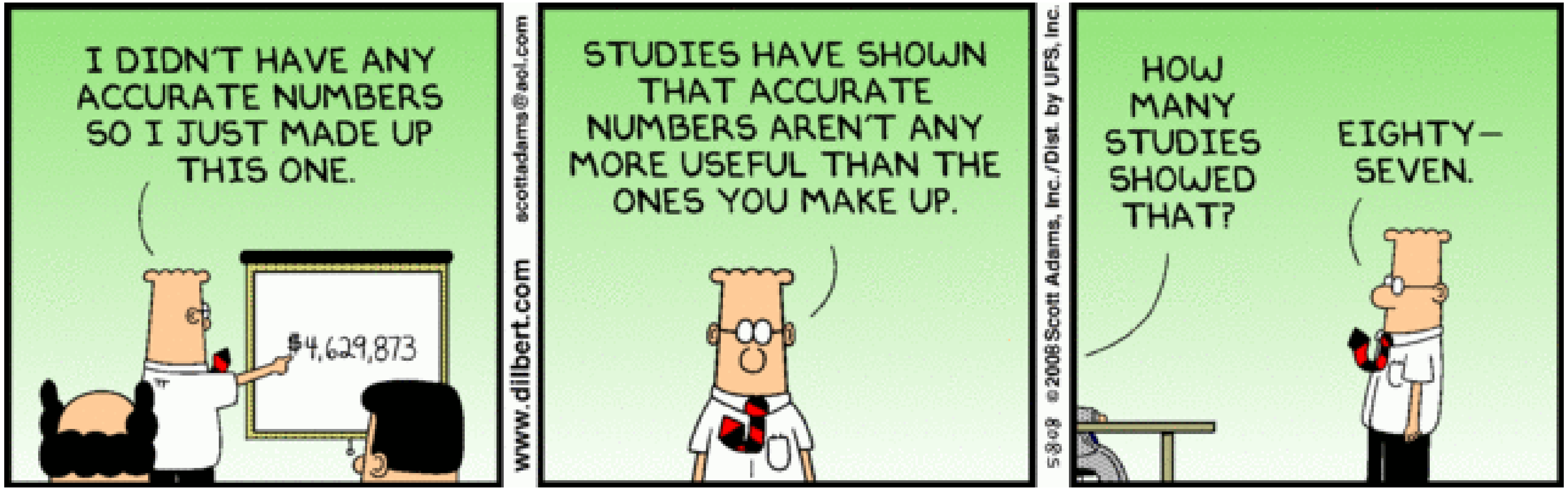
"Half of the numbers are accurate, that's why we're auditing the remaining 56%."

Coming up in the next lecture…

Lecture 06: Receivables (Chapter 7)

- Accounts Receivable (AR)
  - Direct write-off method vs Allowance method to account for impairment of AR
  - Assessment of impairment under allowance method
- Notes Receivable
- FSA:
  - Accounts Receivables Turnover
  - Average Collection Period

That’s all for today!



Post any questions/discussion in the Canvas Discussion Forum.

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