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Welcome to the second edition of the FTI Consulting Global Insights Asia Report. These reports aim at providing useful and informative analysis of the increasingly complex legal, regulatory and economic environment across the region. If you have any questions or suggestions, please do not hesitate to contact me.

In this edition of the Asia Report, Mark Chadwick and Catherine Williams share their insights on Financial Statement Fraud. Both Mark and Catherine are Senior Managing Directors at FTI Consulting - Mark is based in both Singapore and Shanghai and he has more than 16 years of experience working in corporate turnaround, financial advisory and forensic accounting. Catherine works out of our Hong Kong office, where she specialises in forensic and litigation consulting and has over 20 years of experience in accounting.

In this article, my colleagues look at the ways in which the management of companies might use accounting information to mislead stakeholders. Financial misstatement was the most expensive category of occupational fraud during 2010, and is something that investors looking at opportunities in Asia need to be increasingly aware of.

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Financial statement fraud - the numbers game

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The insolvency arena will always be a rich picking ground for the fraud investigator. It is well known by practitioners and academics alike that fraud follows a recession. The game of musical chairs comes to an end when the recession bites and invariably, companies built like a house of cards are exposed by their fraudulent activities.

An important aspect of both a boom and bust is the role of accounting information and the way by which management may use it to mislead stakeholders, commonly referred to as financial statement fraud.

Fraud in Asia

Professionals today should be familiar with the

Moulin - a highly complex morass of 'dodgyness'

Financial statement fraud in Asia has seen some high profile owners and directors prosecuted in recent years. The criminal trial of one of Hong Kong's well-known fraud cases finally came to an end in the closing weeks of 2010 after a lengthy investigation.

The founding Chairman of Moulin Global Eyecare Holdings Limited, his son the CEO, and the Treasurer, the Chairman's sister-in-law, received some of the longest jail sentences for commercial crime in Hong Kong's history. Judge Pine, in his summing up, commented that "the inflow of funds into Moulin

prevention and detection of all types of occupational fraud. Occupational frauds usually fall into one of three categories:
(i) asset misappropriation;
(ii) corruption schemes; and
(iii) fraudulent financial statements.

A May 2010 fraud survey carried out on companies in the Asia-Pacific region, titled 'ACFE 2010 Global Fraud Study - The Report to the Nations on Occupational Fraud and Abuse (Asia-Pacific Edition)' found that the typical organisation loses around 5 percent of its annual revenue to fraud.

Anti-corruption issues currently attract far greater focus by the compliance of companies and individuals with the FCPA and impending UK Bribery Act. But of the three categories of fraud, financial misstatement was the most expensive category of occupational fraud, accounting for 51.2 percent (versus 33.9 percent for asset misappropriation and 14.9 percent for corruption) and the losses tended to rise with the authority of the perpetrator.

Studies of financial statement frauds over the last decade illustrate that 89 percent of financial statement fraud was perpetrated by either the CEO or the CFO who was a member of the board during the fraud period. This is an increase on the 83 percent for the previous decade, according to 'Fraudulent Financial Reporting 1998-2007 An Analysis of US Companies', a report released by COSO in May 2010.

Classic fraud theory explains the motivations for fraud as a triangle of perceived opportunity, pressure and rationalisation of actions. We note, however, that these motivations operate at different spectrums in boom times as compared to bust.

Keeping up appearances - the boom times

In boom times, the motivation for management to engage in financial misstatement through 'aggressive accounting' practices and the manipulation of accounting data varies, but recent studies suggest the key motivations are:
(i) meeting market analysts' expectations of earnings; (ii) meeting internal budgets and financial forecasts; (iii) concealing the company's poor performance or deteriorating financial position;
(iv) increasing the share price;
(v) bolstering the financial position ahead of a debt or equity issue;
(vi) increasing management compensation through bonuses or stock options; and
(vii) covering up misappropriated assets.

The cover-up - the bust

A recession invariably adversely impacts liquidity and, in instances where a company's cash holdings and receivables are materially overstated, provides the right environmental setting to expose the true financial position. A recession puts pressure on the company to rearrange its balance sheet and financial structure generated by this fraud required false accounting on a prodigious scale".

Moulin was established in 1960 as a small family managed business engaged in the design, manufacture and retail of eyewear products. It rapidly expanded its operations in the PRC, listing in Hong Kong in 1993 and becoming one of Asia's largest optical groups.

In 2005 Moulin was placed into provisional liquidation after a delay in filing its financial statements, and having appeared to overstretch its capital reserves following the acquisition of a US optical retail chain. In Moulin's case, the detection of the fraud was what crystallised the insolvency of the group.

The Moulin case is not unique, but it is a good example of pervasive fraud and is a classic example of the fraud triangle. Whilst not the biggest fraud by monetary value (approximately US$540m), it may well be one of the longer frauds (aside from Madoff) as it was perpetrated over a period of more than 12 years before being uncovered.

So what are the common methods of financial statement fraud?

The Moulin case encompassed many of the most frequently used methods of fraudulent reporting. It began with the overstatement of revenue by fictitious sales, and evolved over time to include false and inflated asset values, window dressing of cash balances at year end, and an elaborate trade finance fraud using nonexistent purchases from suppliers set up by management.

Trade finance fraud is at the top of the list of methods being used to supplement cash flow and avoid detection of creative accounting in the financial statements. This product line is particularly profitable for banks by virtue of the high volume of transactions over the short term. It is an extremely competitive market, and companies are easily able to arrange facilities with multiple banks with little or no checks on creditworthiness.

So what are the red flags to look for in trade finance fraud?

Company earnings that have been inflated artificially, whether through aggressive accounting practices, or financial statement fraud, will not provide tangible operating cash flow for the company. Companies engaging in financial statement fraud generally have earnings growth that is not accompanied by a corresponding growth in operating cash flow. Over extended periods, the rate of growth in earnings should track the rate of growth in operating cash flow, therefore any lasting discrepancy in their rates of growth is a red flag and should be investigated.

A quick and effective test is the financial ratio of working capital to sales which shows the cash required to maintain a certain level of sales.

High volume, low cost businesses that cycle through their inventory rapidly (e.g., supermarkets) may only including the write down of assets, a process that often enables the original misstatement to be 'un-wound'. There is typically greater focus on the carrying value of assets and the fraudsters will become more focused on the cover up. The key motivation here is therefore to avoid detection.

Many frauds are only discovered when a company enters (or just before it enters) formal insolvency proceedings. Historically, financial statement fraud in Asia has been less likely to be discovered by auditors than in other jurisdictions. Whilst there is no real consensus as to why, some theories suggest the traditional Chinese family owned and controlled company plays a role, which is further accentuated by related party and off balance sheet transactions.

need 10 to 15 percent of working capital per sales dollar. Whereas low volume, high value businesses with a slow inventory cycle (e.g., mining equipment) may require 20 to 25 percent working capital per sales dollar.

Warning signs

Fraudulent companies often show net working capital to sales ratios that are off the scale, as illustrated in the following examples: Moulin Global Eyecare with 109 percent, Ocean Grand with 52.87 percent and Peace Mark Holdings with 33.97 percent.

Ultimately, given the higher dollar cost associated with financial statement fraud and the impact on a wider range of stakeholders, it is surprising that it has less focus than the highly publicised anti-corruption and bribery activities.

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