Catapult

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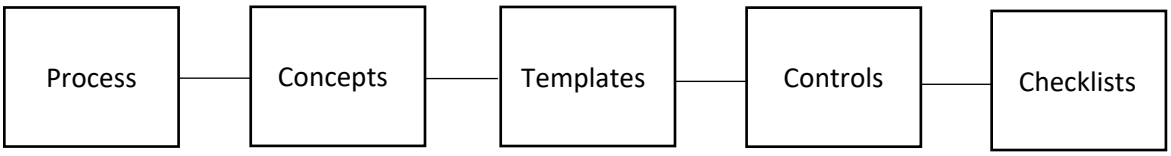
TYPES OF ARTIFACTS USED IN CATAPULT FORENSIC ACCOUNTING IN LITIGATION BEST PRACTICES V1.0



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1. THE ADVERSARIAL NATURE OF FINANCIAL REPORTING

The pursuit of accurate financial profiles of entities requires tenacity because financial statements often conceal more than they reveal. Genuinely valuable analysis begins after all the usual questions have been answered.

PURPOSE OF FINANCIAL REPORTING. Analysts who believe in the inherent reliability of GAAP numbers and the good faith of corporate managers misunderstand the essential nature of financial reporting. A corporation exists for the benefit of its shareholders, with an objective to maximize wealth, not educate the public about its financial condition. Management's job is to obtain the lowest interest rate at which to borrow, and the highest stock price at which to sell stock, thus enhancing shareholder wealth. The best financial statements produce the best credit rating. The best possible outcome is a cost of capital lower than the corporation deserves on its merits. The purpose of financial reporting is to obtain cheap capital.

THE FLAWS IN THE REASONING. Neither the fear of antifraud statutes nor enlightened self-interest invariably deter corporations from 'cooking the books', primarily because the organizational context in which financial reporting occurs.

When major financial reporting violations come to light, the real scandal involved is what is not forbidden. Corporations routinely smooth their earnings, creating the illusion that their profits rise at a consistent rate from year to year. The appearance of smooth growth receives a higher PE multiple from stock market investors than the jagged reality underlying the numbers. Volatility is regarded as an evil to be avoided at all costs. Borrowing sales from the next quarter or run up of expenses in the current period normally undertaken in a later quarter are gimmicks not forbidden by auditors. Sound principles of accounting theory represent only one ingredient in the stew of financial reporting.

Issuers and users of financial statements also have representation on the Financial Accounting Standards Board (FASB), the rule making body that operating under authority delegated by the SEC. Highly charged issues, like executive stock options and mergers lead to confrontations between FASB and the corporate world. Corporate executives have their own agendas, personal or corporate.

Aligning management and shareholder interests has a dark side, as corporate executives can no longer pursue their own agendas and the financial reporting tricks that are readily detectable by investors. Now they must devise better-hidden gambits that fool the market and artificially elevate the stock price.

SMALL PROFITS AND BIG BATHS. The standard of disclosure seems to be that if nobody happens to ask about a specific event, then declining to volunteer the information does not constitute a lie. Research from Rickard Zeckhauser has compiled evidence that lack of perfect candor is widespread. Corporations post small increases far more frequently than they post small declines (small losses are coverable into small gains via the locating of discretionary items). If losses are too big to erase through discretionary items, circumstances create an incentive to take a big bath by maximizing the reported setback by accelerating future expenses
into the current loss-making quarter thereby ensuring positive reported earnings the following period. Among the popular methods for pursuing this line of wealth maximization opportunity aside from the 'big bath' are maximizing growth expectations and downplaying contingencies.

MAXIMIZING GROWTH EXPECTATIONS. A decline in expected earnings is very common, not at all unique. Analysts must weigh facts objectively. Senior managers will invariably try to dispel the impression of

decelerating growth, since that perception can be so costly to them. Simple mathematics will make false profits of attempts to extrapolate high growth rates into the future.

LIMITS TO CONTINUED GROWTH. Once growth begins to level off, restoring it to the historical rate requires overcoming several powerful limitations: (i) saturation – everybody who cares to will own your widget, at which point sales will be limited to replacement plus growth in population, (ii) entry of competition – rare is the company with an offering that cannot either be copied or encroached on, (iii) increasing base – it is arithmetically impossible for volume to increase indefinitely, a growth rate in excess of GDP annual increase is nearly impossible to sustain, and (iv) market share constraints – the firm must eventually bump up against a ceiling on further growth at a constant rate. All growth stories must come to an end.

RATIONALIZATIONS FOR DECLINING GROWTH. Commonly heard rationalizations include: (i) our year over year comparisons were distored must remember that in many past instances short-term supposed aberrations have turned out to be advance signals of earnings slowdowns), (ii) new products will get growth back on track (mature product line growth eventually becomes untenable, so management will have a new product or two to show off – these have higher risk), and (iii) we're diversifying away from mature markets (hunger for growth is key driver of 'diversification').

DOWNPLAYING CONTINGENCIES. A second way to mold disclosure to suit the issuer's interest is by downplaying extremely significant contingent liabilities. Mandeville's 1982 bankruptcy brought forward the specter that a bankruptcy due to legal claims was entirely possible. Surprise at such events is a function of disclosure. Executives in a contentious suit are conflicted as it would be difficult to testify in defense of their company and simultaneously acknowledge to investors the plaintiff's claims have merit.

THE IMPORTANCE OF BEING SKEPTICAL. Analysts should view issuers as adversaries in the same manner that they temporarily demonize their athletic opponents. Learn to understand the gamesmanship of financial reporting and even learn to appreciate the cleverness of the issuers who constantly derive new strategies for leading investors off the track. Financial reporting occurs in a context that obliges conscientious analysts to go many steps beyond conventional calculation of financial ratios.

It can be difficult for institutions to maintain a high degree of skepticism. The need for easy to use financial information that can be constantly updated makes thorough financial analysis a tough sell for an analyst in such an institution. Same with credit departments and their 'credit approval process'. There is an inherent bias toward extending credit. For a credit manager to achieve the optimal growth of a portfolio of loans, the analyst must approve a certain number of accounts that will eventually fail to pay – in effect having to make mistakes.

Every high-risk company seeking a loan can make a plausible soft case for overriding financial rations keeping them in the un-approvable zone.

CONCLUSION. Analysts must consider the motivations of corporate managers and the dynamics of their organizations as these will impact the underlying intent of issuer's communications with users of financial statements. Organizations should be viewed as an aggregation of individuals with diverse motivations. The burden of proof lies with those making the disclosures, basic financial statements. Methods for uncovering the information they conceal as well as what they reveal are below.

Limits to continued growth: (i) saturation, (ii) entry of competition, (iii) increasing base, (iv) market share constraints.

Commonly heard rationalizations for declining growth: (i) our year over year comparisons were distorted, (ii) new products will get growth back on track, (iii) we're diversifying away from mature markets.

Downplaying contingencies: (i) difficulty of incorporating legal risks – out of court settlements, disclosure of information during trial, susceptibility of juries, (ii) Manville's 1982 bankruptcy, (iii) issuer's point of view, (iv) deliberate dishonesty.

Why is tenacity so essential to the analysis of financial statements? Tenacity is essential because financial statements often conceal more than they reveal. To the analyst who pursues this proactive approach, producing a standard spreadsheet on a company is a means rather than an end. Investors derive but little satisfaction from the knowledge that an untimely stock purchase recommendation was supported by the longest row of figures available in the software package. Genuinely valuable analysis begins after all the usual questions.

Since a corporation exists for the benefit of its shareholders, what can be said about the purpose of financial reporting? *The purpose of financial reporting is to obtain cheap capital.*

What are the three ways corporations can use financial reporting as a means to enhance value? For class discussion on this point it is useful to refer to a simple Dividend discount Model.

P= D/k-g. Dividends are a proxy for cash flows; firms want to appear to have large sustainable cash flows. Lower the perceived risk, thus lower cost of capital. Maximize growth expectations.

In addition to double counting of revenue, what other items were part of Interpublic's misreporting? It also turned out that the misreporting was not limited to double-counting of revenue by McCann-Erickson's European offices. Other items included an estimate of not-yet-realized insurance proceeds, write-offs of accounts receivable and work in progress, and understated liabilities at other Interpublic subsidiaries dating back as far as 1996. In May 2008, the company paid $12 million to settle the SEC's accusation that it fraudulently misstated its results by booking intercompany charges as receivables instead of

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What is the real scandal involving major financial reporting violation when they come to light? When major financial reporting violations come to light, as in most other kinds of white-collar crime, the real scandal involves what is not forbidden. In practice, generally accepted accounting principles countenance a lot of measurement that is decidedly inaccurate, at least over the short run.

What is the dark side of aligning management and shareholder interests? Aligning management and shareholder interests, it turns out, has a dark side. Corporate executives can no longer increase their bonuses through financial reporting tricks that are readily detectable by investors. Instead, they must devise better-hidden gambits that fool the market and artificially elevate the stock price. Financial statement analysts must work harder than ever to spot corporations' subterfuges.

In which way should the analyst consider the issuers of financial statements as adversaries? Rather, analysts should view the issuers as adversaries in the same manner that they temporarily demonize their

