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Fraud isn't likely to disappear

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Allen Stanford is among a long list of fraudsters. Aaron M. Sprecher/Bloomberg

Accounting and securities frauds continue unabated and in increasing amounts. The recent conviction of financier R. Allen Stanford on 13 counts of fraud involving US$7-billion — including money laundering and obstructing investigators – is the most recent example, but not the last.

The methods vary depending upon the underlying purpose: managing earnings to boost financial performance, stock prices and executive bonuses; evading income taxes; or just old fashioned Ponzi selling.

North America has seen its fair share of all these types of fraud over the years.

We see confidence, creative bookkeeping, and the respectability of pedigree — the essential ingredients of fraud — in McKesson & Robbins, a classic case from the late 1930s in which Canada played a leading role.

The story begins with Philip Musica — a high school dropout — twice convicted of commercial fraud. Upon his release from prison, Musica reincarnated himself as "F. Donald Coster" and upgraded his academic pedigree by conferring upon himself two advanced degrees, an MD and a PhD from Heidelberg University — the most elite and respected educational institute in Germany at that time. The newly minted "Herr Dr. Dr. Coster" then acquired McKesson & Robbins — a publicly listed pharmaceutical company on the New York Stock Exchange.

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Coster wanted to make the company look successful and profit from its publicly listed shares. He incorporated a Canadian company in Windsor, hired his cousin and bought five typewriters. Coster and his cousin then created a fictitious paper financial empire. They did all the things accountants do, but without any underlying business. They typed fictitious sales, purchase and delivery invoices — each on different typewriters — and created substantial paper profits. They went through the entire accounting cycle, recording non-existent inventories and account receivables of about $35-million on the company's books.

McKesson & Robbins had to comply with securities laws and the formalities of preparing financial statements. The company retained one of the most respectable blue-chip accounting firms — Price Waterhouse — as its auditors. As a director of the company testified at trial, "I just took it that when you put PW on the bottom of a statement, it was sterling silver, and everything went." The markets bought the fiction. The company's stock soared.

In 1937, auditing standards did not require auditors to "kick the tires" by physically examining inventories or confirming accounts receivables with debtors. PW auditors phoned Coster's cousin in Windsor. He confirmed that all was well with the Canadian subsidiary and that they had all assets on hand. Coster managed to conceal his fraud for 12 years, always showing substantial inventories and accounts receivable on the books from ever-increasing fictitious sales.

The bubble eventually burst and Coster put a gun to his head. The accounting profession learned a lesson and changed its auditing standards to require physical inspection of all material inventories stated on the financial statements. The company survived, too; McKesson Corp. is today one of the largest pharmaceutical and medical technology companies in the world.

In what has come to be called the Great Salad Oil Swindle of the 1960s, Anthony "Tino" DeAngelis turned to science to perpetrate his fraud. DeAngelis controlled Ally Crude Vegetable Oil and Refining Corp. Ally's auditors — having learned the risks of not physically verifying inventory in McKesson & Robbins — physically inspected the company's inventory of salad oil at a "tank farm" in New Jersey. They examined each barrel of oil and even inserted a dipstick into the tanks to ensure that they actually contained oil.

However, not all auditors are versed in Archimedean principles. Having created phantom inventory through fictitious warehouse receipts and inventory records, DeAngelis filled the tanks with water and added a little bit of oil. Since oil floats on water, the dipstick readings did not detect the depth of the oil. As the auditors moved ahead from tank to tank with their dipsticks, the company's employees repainted the numbers on the tanks behind them. Thus, as in a Marx Brothers comedy, not only did the auditors count water as oil, but they also counted the same water as oil over and over, thereby multiplying the value of the company's inventory.

The Crazy Eddie fraud had an unusual twist. Eddie Antar was an officer, director and employee of Crazy Eddie Inc., a chain of consumer electronic stores. New York-based Crazy Eddie's management initially falsified the corporate books in the traditional manner — they skimmed cash at their stores and paid employees "off the books." Management reduced corporate taxable income by approximately 20%, and the family deposited more than US$6-million between 1980 and 1983 in offshore bank accounts.

However, Antar's success became his albatross: Where to hide the skimmed money? The Antar family decided to cover up their fraud by going public! Prior to going public, however, they decided to skim less money each year. By stealing less, they increased profit margins and net income. Actual profits rose by 13% from 1980 to 1983. The company's reported profits rose by more than 170%.

The company went public in September 1984 (CRZY) on the Nasdaq at a price of about US$8. Within 18 months, Crazy Eddie stock traded at more than US$75 per share (after accounting for share splits).

The frauds would have remained undetected had it not been for Eddie's bedroom antics. Eddie became involved in an extramarital relationship and was caught out by his wife on New Year's Eve. He learned that hell hath no fury like a woman scorned. The entire fraud, which had been a nice family enterprise, unravelled. At trial Eddie Antar admitted that he caused the value of the inventory of Crazy Eddie that he reported to the auditors to be overstated by about US$2-million. He also admitted to falsifying the inventory counts during physical inventory, which overstated inventory by about US$10-million.

As accounting and securities frauds evolve and become more sophisticated, they retain their basic features: overstate, understate and shift income between fiscal periods depending upon the ultimate goal. In respectable circles, we speak of this as "earnings management."