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IN DEPTH: CORPORATE ACCOUNTABILITY

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Detecting Fraud

Scour annual reports for abnormalities

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Do you remember the classic scene from the movie "Network"? A frustrated TV newsman loses his tolerance for circumstances beyond his control and urges viewers to do likewise and throw open their windows and shout, "I'm as mad as hell, and I'm not going to take this anymore!" And a coast-to-coast phenomenon ensued.

An analogous scene has played out in the corporate world in the wake of accounting scandals that fleeced investors and, in some cases, wiped out employees' life savings. Public outrage has led Congress to overcome partisan differences to pass the Sarbanes-Oxley Act. The legislation aims to protect investors by improving the accountability of publicly traded companies.

It's hardly surprising that some businessmen who are being prosecuted under the act are challenging the legislation in court; maybe it's working.

How'd that happen?

Enron Corp., WorldCom, HealthSouth Corp. and other scandals have left investors wondering, "How did this happen? ... Who was in charge? ... Were the board members asleep at their posts?" Those questions are difficult to answer.

The Enron board was a "who's who" of corporate talent. The audit committee was chaired by an accounting expert who also was a former dean of the Stanford University Graduate School of Business, but the board failed miserably when it came to carrying out its duty to protect the interests of the company's shareholders.

Just as innocents cannot possibly defend themselves from the brutal acts of terrorists, investors will never be able to fully protect themselves from the financial devastation caused by corporate predators who misuse the money and the confidence pumped into their companies.

The disturbing truth is that in most of the recent scandals, the fraudulent practices were so sophisticated as to defy detection until irreversible damage already was done.

Seek out red flags

While fraud can be prosecuted, but not always prevented, shareholders can take practical steps to protect their interests by increasing their knowledge of the internal workings of the companies they are investing in.

The minimum diligence required of any investor is a yearly review of the company. An examination of the annual report provides a convenient way to do this. If you own shares in a company you should receive a copy in the mail. Read it this time.

Look for the "red flags." If I had to name the most important trait of a 2004 investor - it is skepticism. First, understand the business - if it's not clear in the annual report, don't buy it.

Read and understand the annual report. A quick analysis of debt ratios, the balance sheet and cash flow statements can give you a snapshot of a company's financial health.

Compute debt ratios. Is a company's debt higher than that of other companies in their industry? On the balance sheet, look for big swings or abnormal fluctuations from period to period. Look for estimates in the balance sheet - anything that involves an estimated calculation should be thoroughly explained.

Examine the cash flow statement. If cash flow from operations is lower than cash flow from investing, the company probably is increasing debt. If sales are increasing and cash flow is decreasing - find out where the money is going.

Scrutinize the following items in the footnotes of a financial statement: related party transactions - potential conflicts of interest or loss of a business opportunity; litigation - pending, threatened or actual, changes in accounting methods or estimates; stock options granted to executives; pension funding; commitments to purchase over the long term; and vague accounting policies.

Also review management compensation. When bonuses, stock options or other incentives are contingent upon achieving unduly aggressive targets for operating results, financial position or cash flow, unusually aggressive accounting practices may come into play.

High turnover of senior management, domination of management by a single person or small group, unduly aggressive financial targets and unrealistic earnings commitments all can signal deeper problems.

Research the board of directors. The board members should be independent of the CEO and management. Board members should enhance the value of the company, either public or private, with comprehensive knowledge of the company's industry and have a wide network of industry contacts.

Board members also should have significant skills in management, marketing, operations or finance. Unlike the past - where board members spent little time really governing - the member should have enough or sufficient time and a genuine interest in aiding and serving the best interest of the company.

Skepticism is healthy

Tap all available resources. Proxy statements are not part of standard financials, but they give a good idea about stock options, perks and compensation - and they are part of Securities and Exchange Commission filings. Understand what you are reading - remember that Pro Forma statements are "wanna be" statements - not actual statements. Look for the 8-K's - they are required by the SEC when there are significant developments of interest - change of auditors, change in CFO or other major occurrences.

The following Web sites provide helpful information:

- www.sec.gov (Securities and Exchange Commission);
- www.freeedgar.com (FreeEDGAR: free real-time SEC EDGAR filings);
- www.fiu.edu/~morriss/Guides/cosi publ.html (Guide to finding information on U.S. public companies).

As stockholders and board members kick diligence up a notch, accounting fraud cases are making their way through the justice system. Investors may take token consolation that greed, arrogance and deceit can fell the mighty. However, most investors doubt that it will offer significant help to victims in the recovery of their financial losses.

History is repeating itself - at least somewhat. Remember the scandals that plagued the savings-and-loan industry during the 1980s? Corporate governance regulations were enacted to correct weaknesses that existed then in the financial services industry.

Congress gave regulators broad authority to deal with problem banks and to handle those problems swiftly. Because of those actions, many feel that the financial services industry now is much healthier and will have fewer corporate governance issues than the typical company.

With Sarbanes-Oxley, vigorous prosecution of suspected corporate criminals, and a healthy dose of investor skepticism, publicly traded companies are undergoing their own corporate governance shake-up. Accountability is moving to an appropriate level of importance.

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