San Antonio ISACA Chapter
June 7, 2022

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Mary Breslin is the Founder of Verracy and specializes in Internal Audit transformations, Operational and Financial Auditing, Fraud Auditing & Investigations, and Corporate Accounting.

Ms. Breslin’s career spans over 20 years in Internal Auditing, Management, and Accounting for companies such as ConocoPhillips, Barclays Capital, Costco Wholesale, and Boart Longyear. With significant international experience, she has managed audit programs in more than 50 countries.

Most recently, Ms. Breslin held the title of Vice President and Chief Audit Executive where she transformed a checklist audit function into a value-add audit department delivering measurable business results. Mary was an early adopter of analytics and has been utilizing data analytics in audit and fraud work for over 15 years.

Through her expertise, she has helped large global organizations leverage analytics to increase coverage, automate continuous auditing and monitoring, and actively fight fraud. Additionally, Ms. Breslin has conducted major fraud investigations on multiple continents including large-scale federal cases.

Ms. Breslin attended Rutgers University and received an M.B.A. from the University of Phoenix while living and working overseas. She is a member of the Institute of Internal Auditors (IIA), American Institute of Certified Public Accountants (AICPA), ISACA, the Society of Corporate Compliance (SCCE), and the Association of Certified Fraud Examiners (ACFE), and is currently an instructor and conference speaker for the IIA, the ACFE, and ISACA.

Learning Objectives

Why valuation, estimates, and reserves provide opportunity for financial statement manipulation

How the pandemic makes all valuations and estimates more subjective and provides opportunity and concealment for financial statement fraud

What auditors, fraud examiners, and others should be reviewing and what questions they should be asking
Accounting estimates and valuations are difficult in the best of times.

Anyone still own an iPhone 4?
How much is it worth?

$0?

$10?

$25?

$100?

Is it reasonable if I argued...
$0
Who wants an 11-year-old phone?

$9
Worldwide market

$25
Scrap buyer

$100
Ship to Africa
Now the difference is significant.
Consumption and production changed dramatically during the pandemic.

Accounting estimates are generally dependent on specialized knowledge and judgment, which are dependent on experience and training.
Accounting Estimates require judgment of future benefits and obligations likely to occur.

Estimates are based on information reflecting the circumstances that exist on the date of the estimation. This creates subjectivity.
Who has prior experience with a pandemic and worldwide disruption?

Anyone?

Anyone?
Experts assumed the pandemic would slow down home buying and, as a result, sawmills reduced production.

The experts were wrong.

For years, the price of 1,000 board feet of lumber has traded at $200–$400.

It hit $1,670 in May 2021.

It is now at $936.
Economists, realty groups, home construction companies, and sawmills all used their industry knowledge and experience to estimate what would happen due to COVID, and they got it wrong.

“Not only has it surprised me, it’s surprised the whole industry, how quickly we came roaring back. Housing and construction, repair and remodel, that’s where so much money was pointed by American consumers that the sheer scale of demand was hard to fathom.”

~Stinson Dean, CEO of Deacon Lumber
No one *anticipated* this either...

**Most Common Significant Estimates**

- Accounts Receivable Bad Debt
- Inventory Impairment
- Fixed Assets Impairment
- Depreciation Method and Useful Life
- Goodwill
- Contingent Liabilities
- Warranty Estimates
- Pension and Post-Retirement Obligations
- Credit Losses Allowance
Most Common Significant Estimates

- Accounts Receivable Bad Debt
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- Goodwill
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### Accounts Receivable Bad Debt Reserve

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<thead>
<tr>
<th>Customer</th>
<th>Current</th>
<th>1-30 Days</th>
<th>31-60 Days</th>
<th>61-90 Days</th>
<th>91+ Days</th>
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<tbody>
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<td>$7,750</td>
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</tr>
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Money set aside by an organization to cover receivables that might not be paid by customers.

Total amount of receivables the company does not expect to collect.

**Bad debt reserves** are calculated using history and current economic conditions to calculate an estimated % of non‐collectible receivables.
If a company was unable to collect 5% of receivables in the past few years and have $100 million in current receivables, the bad debt allowance would be $5.0M.

\[
\$100M \times 5\% = \$5.0M
\]

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On the Balance Sheet:

- Accounts Receivable: $100,000,000
- Allowance for Doubtful Accounts: ($5,000,000)
- Net Accounts Receivable: $95,000,000

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This $5.0M is an expense. It reduces profit.
Bottom line: That $5M –

Reduces profitability AND negatively impacts balance sheet ratios.

$300M in receivables and 5% bad debt allowance allow $285M Net Accounts Receivable

Balance Sheet

Current

Past Due

Customer | Current | 1-30 Days | 31-60 Days | 61-90 Days | 91+ Days | Total Receivables

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### Table: Receivables Summary

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**Question:** How do we know it should still be 5% in 2021?

**Answer:** The current financial state of your customers suggests that the 5% still applies.

**Question:** What is the current financial state of your customers?

**Answer:** The current financial state of your customers indicates that the 5% is still applicable.
What if it should really be 15%?

$300M in receivables and 15% bad debt allowance = $255M Net Accounts Receivable

**Common Ratios**

- **Current Ratio**: 1.2
- **Quick Ratio**: 0.9

Considered a red flag to analysts and investors.

### Balance Sheet

**Current Assets**:
- Cash: $190.5M
- Accounts Receivable (net): $255.0M
- Short-term Investments: $82.9M
- Supplies Inventory: $125.8M
- Prepaid Expenses: $60.5M
- Total current Assets: $714.7M

**Fixed (Long-term) Assets**:
- Equipment: $143.0M
- Land: $552.5M
- Buildings: $1,265.8M
- Total Property, Plant & Equipment: $2,050.2M
- Less Accumulated Depreciation: $256.3M
- Net Property, Plant & Equipment: $1,793.9M

**Other Assets**:
- Deferred Income Tax: $5.5M
- Long-term Investments: $25.6M
- Total Other Assets: $31.1M

**Total Assets**: $2,539.7M

**Current Liabilities**:
- Accounts Payable: $245.6M
- Accrued Wages Payable: $105.8M
- Accrued Expenses: $50.6M
- Deferred Revenue: $75.5M
- Short-Term Loans: $80.5M
- Total Current Liabilities: $558.0M

**Long-Term Liabilities**:
- Long-Term Debt: $450.8M
- Total Long-term Liabilities: $450.8M

**Total Liabilities**: $1,008.8M

**Equity**:
- Retained Earnings: $1,155.7M
- Owner Investment: $375.2M
- Total Equity: $1,530.9M

**Total Liabilities & Equity**: $2,539.7M
The effects of COVID-19 might **materially impact** significant estimates and **increase vulnerability** due to certain **concentrations**. (e.g., business concentration in a market severely affected by COVID-19). Risk is increased in certain industries such as restaurants, hotels, and airlines.
How many planes are still in storage?

When an “asset” is no longer generating revenue (cash flow) it should be impaired.

Adjust the book value – write-down or write-off – to the recoverable amount.
Just for an example, let’s look at the impact COVID had on:


I chose American because of their transparency and seemingly appropriate response to the pandemic.
“Long-lived assets consist of owned flight and ground equipment, ROU (Right-of-Use) assets and definite-lived intangible assets such as certain domestic airport slots and gate leasehold rights, customer relationships and marketing agreements.

In addition to the original cost, the recorded value of our fixed assets is impacted by a number of estimates made, including estimated useful lives, salvage values and our determination as to whether aircraft are temporarily or permanently grounded.

The majority of our aircraft fleet types are depreciated over 25-30 years. It is possible that the ultimate useful lives of our aircraft will be significantly different than the current estimate due to unforeseen events in the future that impact our fleet plan.”
“Accounting Standards Codification (ASC) 360 – Property, Plant and Equipment (ASC 360) requires long-lived assets to be assessed for impairment when events and circumstances indicate that the assets may be impaired.

An impairment of a long-lived asset or group of long-lived assets exists only when the sum of the estimated undiscounted cash flows expected to be generated directly by the assets are less than the carrying value of the assets.

We group assets principally by fleet-type when estimating future cash flows, which is generally the lowest level for which identifiable cash flows exist. Estimates of future cash flows are based on historical results adjusted to reflect management’s best estimate of future market and operating conditions, including our current fleet plan.

If such assets are impaired, the impairment charge recognized is the amount by which the carrying value of the assets exceeds their fair value. Fair value reflects management’s best estimate including inputs from published pricing guides and bids from third parties as well as contracted sales agreements when applicable.”

American Airlines

The estimates (so far):

• Future cash flows (based on future sales)
• Number of planes temporarily or permanently grounded
• Salvage value (impacted by market demand)
• Useful lives (impacted by long-term storage)
Asset groups are used when it is too difficult to determine cash flow from a single asset but can be determined for a group of assets.

Like a production line in a manufacturing plant.
American Airlines

American retired the following asset groups:
- Airbus A330-200s
- Airbus A330-300s
- Boeing 757-200s
- Boeing 767-300ERs
- Embraer E190s

Asset-group accounting makes sense for normal operations—airlines buy planes they intend to use.

The plane is therefore a revenue earning asset.

Assets not in use, not earning revenue, should be impaired.

With asset groups, the “group” must be earning revenue.

While the “group” is earning revenue, there can be some individual assets within the group that are not.

How many planes does it take to be grounded to reach the “tipping point” in an asset group where cash flow is less than the book value of the asset group?

I bet the FP&A folks are calculating furiously to figure that out!

As of May 2021, air travel was still only at 60% of 2019.

As of September 2021, air travel was still only at 80% of 2019.

AA plans to return all remaining planes to service by summer 2021.

It takes roughly 1,000 hours of maintenance to get a plane back into service.
"At least once every 10 days, there was a maintenance appointment for every single aircraft: check the engines, check the landing gear, rotate the tires to prevent flat spots."

~ CNN, “How American Airlines Pulls Planes from Pandemic Storage”

“In many ways, we ... actually have more maintenance requirements on the aircraft that has been in storage or is in storage than we do if the aircraft is out actively flying.”

~ Roger Steele, AA Maintenance Manager


Significant changes to operations and accounting
- 2020 operating revenues ↓ 62.1% from 2019
- Retired five aircraft groups (approx. 150 planes)
- Deferred delivery of new aircraft
- Waived change fees for customers
- Reduced flights and flight plans
- Increased maintenance for grounded planes and for those to be put back into service
- $4.75B in cash infusion from U.S. Treasury
Why am I telling you this?

Traditional analysis is *not* going to work.
Trends, ratios, and vertical and horizontal analyses will not provide the same insights they once did.

Correlations and relationships between accounts have changed.

<table>
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<th>Ratios</th>
<th>2020</th>
<th>2019</th>
<th>2018</th>
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<tbody>
<tr>
<td>Salaries to Revenue</td>
<td>63.2</td>
<td>27.7</td>
<td>27.5</td>
</tr>
<tr>
<td>Fuel to Revenue</td>
<td>14.8</td>
<td>16.4</td>
<td>18.0</td>
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<tr>
<td>Maintenance and Repairs to Revenue</td>
<td>9.1</td>
<td>5.6</td>
<td>4.6</td>
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<tr>
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<td>.67</td>
<td>.43</td>
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<td>.57</td>
<td>.35</td>
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It’s complicated.

And confusing.

It’s why it provides opportunity for manipulation.
One last thought:

What if group asset accounting wasn’t used?

What if individual assets (planes) were impaired then ultimately brought back into service?
Gross margin would look like this:

How many companies had to make the decision to impair, or not to impair, individual assets they intend to (or hope to) bring back into production?
Let's look at one more...

We have a microchip shortage.

No one could have anticipated the increased demand in microchips due to the pandemic.

Plants shut down, then everyone needed a device.

Everything from video games, to dishwashers, to the camera for your Zoom meeting uses microchips.
One of the industries hardest hit: the automotive industry.

Production has slowed dramatically, and cars and trucks already built can’t be finished or sold.
Cars are sitting in lots waiting for chips.

Stockpile of unfinished Ford trucks from space
How long can they sit there before it impacts their value?

Before they get damaged?

Before they become last year’s model?

Ford had $6.1 billion in finished goods at the end of 2020.

How much of that is sitting, waiting for chips?

If some of that inventory had to be impaired, what kind of financial impact would that have?
How many other industries and companies have been disrupted to these levels?

How many industries have permanently changed the way they operate?
How much opportunity do you think will arise for potential financial statement manipulation and fraud?

Change can provide natural concealment.
We could be in for a financial *roller coaster.*

What are the real **long-term effects** of the pandemic on your industry? Your company?

How will they be **accounted** for? Explained? Resolved?
All the challenges that your organization is facing, all your _third parties_ are facing them too.

What vendors or customers do you have a _significant reliance_ on?

What potential _risks_ does that create?

What _pressure_ might that cause?

---

**Summary**

Manipulating financials to “stay in business” might be perceived as the greater good.

Significant change to operations, complex accounting rules, lack of history and precedence, and the natural subjectiveness of valuations and estimates will provide ample opportunity for manipulation of financials.

Business struggling to adapt and overcome the impact of the pandemic might have significant financial pressures.
QUESTIONS?

Thank you!

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Mobile: 480-221-0076
Twitter: @Auditchic

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