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Using Topside Journal Entries to Conceal Fraud

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UNIVERSITY HONORS PROGRAM

SENIOR PROJECT - APPROVAL

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PROJECT TITLE: Using Topside Journal Entries to Conceal
Fraud

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

Signed: Jack E. Kiger, Faculty Mentor

Date: 4-23-04

Comments (Optional):

**USING TOPSIDE JOURNAL ENTRIES TO
CONCEAL FRAUD**

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April 22, 2004

ABSTRACT

For my senior project, I chose to do an investigation on topside journal entries. Topside journal entries are adjusting entries made by a parent company to the books of its subsidiaries when preparing consolidated financial statements. Topside journal entries are a normal and necessary part of accounting. For instance, topside journal entries can be used to allocate income or expenses from a parent company to its subsidiaries. Such practice falls within the scope of GAAP. Due to their relative ease of concealment, however, topside journal entries have often been used to perpetrate fraud as well by increasing revenues and decreasing expenses with no valid basis under GAAP. Topside journal entries are most frequently used in fraud when management is under high pressure to conform its financial statements to earnings expectations. Fraudulent misuse of topside journal entries is also common in companies undergoing mergers, acquisitions, or restructuring.

Cendant Corporation and Symbol Technologies, Inc. are two companies whose managers were guilty of using topside journal entries fraudulently to boost financial statement information. While the specific methods of fraud were slightly different, the underlying motives and strategies for committing the respective frauds were striking similar. AU 316 states that three conditions must exist in order for fraud to occur: 1) Management is under pressure or has an incentive to commit fraud, 2) An opportunity to perpetrate fraud exists, and 3) Perpetrators can rationalize committing fraud. All three conditions were present in the two aforementioned cases.

While the fraudulent misuse of topside journal entries might not seem like fraud to some at first impression, it is important to realize that reclassifying real expenses (which are costs incurred to earn past revenues) to assets (which have future value and should generate future revenues) misleads readers of financial statements and is illegal. Such activity promotes a false sense of security among investors and leads to inflated valuation for companies. Furthermore, creating false receivables or booking false transactions is illegal for obvious reasons. Therefore, when examined closely, it is easy to see how such misuse of topside journal entries can result in substantial acts of fraud.

USING TOPSIDE JOURNAL ENTRIES TO CONCEAL FRAUD

In light of recent fraud cases that have plagued business, managers have been forced to realize the importance of the auditing profession now more than ever. In turn, auditors have been forced to reexamine their own profession in order to ensure that their services adequately comply with the needs of their clients. With the passage of the Sarbanes-Oxley Act, managers and auditors alike have been required to change several procedures in their respective professions. Aside from legal decrees, however, understanding past occurrences of fraud and recognizing them in the future is now of utmost importance to auditors.

An alarming phenomenon in accounting in recent years has been the misuse of topside journal entries to perpetrate fraud. Perhaps even more alarming is the failure of the auditing profession as a whole to adequately address this issue. Topside journal entries are adjusting entries made by a parent company to the accounting records of its subsidiaries when preparing consolidated financial statements. Managers can legitimately use topside journal entries for such tasks as allocating expenses (e.g. technology cost, interest expense) and income (e.g. sales, miscellaneous income) from a parent company to its subsidiaries. Such journal entries are normal entries in the course of business and fall completely within the scope of generally accepted accounting principles (GAAP). Due to the relative ease of concealment, however, managers have repeatedly used topside journal entries to perpetrate extensive frauds.

AU 316

AU 316 states that three conditions must exist in order for fraud to occur: 1) Management is under pressure or has an incentive to commit fraud, 2) An opportunity to

perpetrate fraud exists, and 3) Perpetrators can rationalize committing fraud. Recently, managers at two separate companies, Cendant Corporation and Symbol Technologies, Inc., were under intense pressure to ensure that quarterly financial results met Wall Street analysts' expectations. As a result of such burdens, managers at these companies were able to rationalize committing frauds in order to achieve the desired outcomes on their respective financial statements. Managers at both Cendant and Symbol fraudulently misused topside journal entries to inflate financial statement information. Thus, the cases of Cendant and Symbol provide prime examples of how managers can use topside journal entries to engage in substantial acts of fraud.

FRAUD AT CENDANT CORPORATION

Cendant merged with another company in December 1997. Before the merger, Cendant had established a merger reserve to account for anticipated costs related to the upcoming merger. Managers at Cendant used the pooling-of-interests method of accounting to establish the merger reserve and to account for the merger in 1997. This method of accounting, permitted by GAAP at the time, consists of recording certain anticipated costs as liabilities prior to actually incurring these costs. In the case of Cendant, managers did use the merger reserve to record future liabilities related to the merger, but they frequently manipulated this account through the misuse of topside journal entries. Furthermore, managers used another reserve account, the membership cancellation reserve, in a similar manner to carry out their fraudulent activities.

The fraud took place from the years 1995 through 1997. As is the trend with most frauds, managers at Cendant were continually forced to make larger topside adjustments as time progressed in order to inflate annual earnings to expected levels. By the time the

fraud was discovered and Cendant was forced to make a public announcement concerning the fraud, managers at Cendant had overstated the company's operating income for the three-year period by hundreds of millions of dollars.

The problem occurred when managers at Cendant began to routinely overstate restructuring charges in order to increase the merger reserve. Managers also frequently increased the merger reserve by writing off assets they characterized as impaired (as a result of the merger) when, in reality, most of these assets were not impaired. Managers would then use the merger reserve to offset normal operating expenses, a process not acceptable under GAAP. In essence, Cendant created its merger reserve with the intent to use the account not only to record anticipated costs related to the merger, but to fraudulently offset operating expenses unrelated to the merger as well. Using topside journal entries to accomplish this scheme, managers at Cendant were able to improperly manage earnings during the three-year period and had intentions to continue their actions.

The auditors of Cendant were also unwise in certain actions of their own regarding management's misuse of the merger reserve. For instance, auditors provided accounting advice to Cendant's managers concerning costs that are typical in corporate restructurings. Unfortunately, such costs are often subjective in nature and difficult to test. These costs require auditors to rely more heavily on managers' representations than on specific audit evidence. Managers at Cendant were able to use the subjective nature of these costs to conceal various expenses through the misuse of topside journal entries.

Auditors also failed to recognize various other actions of management that did not conform to GAAP. For instance, managers provided the auditors of Cendant with contradictory drafts of schedules when the auditors requested support for the

establishment of the merger reserve. Managers continually revised these schedules to satisfy the auditors' questions or to incorporate new information discovered by the auditors. The schedules, however, were inconsistent with regard to the nature and amount of the individual components of the reserve. Auditors repeatedly relied on these ever-changing representations of management, in part due to the aforementioned subjectivity, and therefore were unable to detect the fraud.

Managers at Cendant manipulated another reserve account, the membership cancellation reserve, to inflate earnings as well. Managers created the membership cancellation reserve to account for members who canceled during their membership periods (and were therefore entitled to refunds) as well as members who were billed for memberships but never paid for them (essentially, bad debts). When members paid for their memberships, typically with credit cards, managers at Cendant would record an increase in both the revenue and cash accounts at the time the credit cards were charged. Issuers of members' credit cards would frequently reject these charges, however, on a monthly basis. Therefore, Cendant would not receive the rejected charges as payments.

When confronted by auditors on this issue, managers falsely claimed that once they resubmitted these rejections to banks, Cendant would ultimately collect nearly all rejections within a three-month period. Furthermore, managers falsely claimed that they recorded a reduction in the cash account and a decrease to the membership cancellation reserve for each of the few uncollected rejections. At the end of each accounting period during the course of the fraud, however, managers failed to record three months of rejections. In other words, managers neither reduced the cash account nor decreased the membership cancellation reserve for the corresponding amounts of the rejections.

Managers at Cendant errantly reasoned that they did not need to record rejections that occurred during the final three months of the year because they would collect most of the rejections within a three-month period of the initial rejection.

The three months of withheld rejections created a temporary difference at the end of the year between the cash balance reflected on Cendant's general ledger and the cash balance reported on its bank statements. Managers falsely claimed that the difference between the general ledger balance and the bank statement balance did not reflect an overstatement of the cash account nor an understatement in the membership cancellation reserve since most rejections would eventually be collected. In reality, however, Cendant never collected the majority of the rejections. By not recording these rejections during the final three months of the year, managers at Cendant drastically understated the membership cancellation reserve and overstated the cash balance. Therefore, managers were able to avoid the expense charges and journal entries necessary to rectify the membership cancellation reserve and cash accounts. As was the case with the merger reserve, auditors of Cendant relied primarily on managers' representations with respect to the membership cancellation reserve and the company's "successful" collection history.

FRAUD AT SYMBOL TECHNOLOGIES, INC.

Unfortunately, Cendant is not the only company whose managers have been guilty of misusing topside journal entries to perpetrate a sizeable fraud. Managers at Symbol Technologies, Inc. also used topside journal entries to perpetrate fraud, and the similarities between what occurred at Cendant and Symbol are striking. From 1998-2002, managers at Symbol perpetrated a fraud that inflated the reported financial results of their company. Managers manipulated reserves and made various improper topside

adjustments to ensure that the financial data of Symbol complied with market expectations.

Managers made dozens of topside journal entries to the accounting records of Symbol that boosted net income and various other financial data by tens of millions of dollars. Throughout the duration of the fraud, managers at Symbol prepared what they called tango sheets. Tango sheets were schedules that compared the results of each quarter to market expectations. Included in the tango sheets were proposed topside adjustments to reserves and various other accounts that would better reflect market expectations. Such topside adjustments lacked valid support and were in gross violation of GAAP. When making the topside journal entries required to create such improper adjustments, managers knew that the results were already inflated due to fraudulent revenue recognition and other similar misconduct. Clearly, the misuse of topside journal entries played a substantial role in the perpetration of this fraud.

Throughout the course of the fraud, managers at Symbol met in closing meetings during which they reviewed each division's results within the company. At the conclusion of these meetings, managers prepared consolidated financial statements consisting of the raw results obtained by the company. Managers then proposed specific topside journal entries based on the accounting "risks and opportunities" presented each quarter. After discussing the necessary topside journal entries, managers posted the entries to the general ledger without public disclosure. As a result of these topside journal entries, managers at Symbol understated expenses and overstated revenues and earnings.

Symbol was a company that was driven by its financial numbers, particularly during the course of the fraud. The primary responsibility of managers was to ensure that the company's financial data met market expectations. Therefore, based on AU 316, the occurrence of fraud at Symbol is not surprising. Managers' response to these pressures was to create a fraudulent scheme that would create the illusion that Symbol had met or exceeded all market expectations. This scheme resulted in numerous misstatements of vital financial information and consisted of blatant disregard for the policies outlined in GAAP.

Similar to Cendant, reserves (often termed "cookie jar" reserves by managers at Symbol), coupled with fraudulent misuse of topside journal entries, were of central importance to the perpetration of this fraud. Symbol maintained a credit memo reserve to account for product returns from customers. Increases to this reserve decreased revenues by the corresponding amounts. When calculating this reserve, however, managers at Symbol did not do so in accordance with GAAP. Instead, managers set the reserve at a desirable level to achieve specific revenue targets. In effect, managers increased the reserve in increments lower than those required by GAAP, which in turn led to a material misstatement of revenues for the related accounting periods.

When making increases to the credit memo reserve, managers simultaneously created a negative effect on both the cost of goods sold and inventory accounts, which in turn decreased gross profit. To lessen the effect such increases had on gross profit, managers at Symbol made additional fraudulent topside journal entries to the credit memo reserve that left the reported revenues unchanged while still improving the reported gross profit. Such adjustments were unfounded in GAAP and were made by

managers solely to present the appearance that Symbol had achieved the gross profit expected by the market.

Managers at Symbol also created an excessive reserve for obsolete inventory in a gross inventory account maintained by the company's operations division. This "cookie jar" reserve was designed to account for obsolete inventory, but in reality it was used to help the operations division meet quarterly expectations. The reserve was beyond any reasonable estimate of the company's exposure for obsolete inventory, and managers at Symbol made topside journal entries to this account in order to significantly distort reported earnings.

Symbol also offered a retirement plan to its senior executives and made annual contributions to the plan. In accordance with GAAP, Symbol created a reserve to account for the expenses associated with the annual contributions. During the time period in which the fraud occurred, some senior executives elected not to receive these benefits in lieu of other benefits offered by the company. Therefore, Symbol was no longer obligated to make annual contributions to the retirement plan for the benefit of those senior executives who had opted out of the plan. Even more importantly, Symbol was no longer obligated to pay retirement benefits to these senior executives.

With these obligations erased, Symbol was left with millions of dollars in excess in the retirement plan reserve. Under such circumstances, GAAP requires managers to establish a schedule for the periodic release of these reserves into earnings. Managers at Symbol, however, chose to fraudulently use topside journal entries to release the unneeded funds in the retirement plan reserve during quarters where the raw financial

results fell short of market expectations. Doing so allowed managers to fraudulently boost earnings when needed, again without proper disclosure.

One year during the course of the fraud, Symbol paid bonuses to its employees for work completed in the previous year. As a result, Symbol was obligated to pay the Federal Insurance Contributions Act (FICA) insurance during the quarter in which the bonuses were paid. GAAP requires the recognition of this expense in the quarter in which it is incurred. Managers at Symbol, however, chose to make topside adjustments that deferred the FICA insurance expense to a later accounting period in order to boost net income during the quarter in which the expense was incurred.

At the end of the same year, Symbol owed and needed to account for more ordinary performance bonuses, as well as some nonrecurring bonuses related to a corporate acquisition. According to GAAP, ordinary performance bonuses are classified as operating expenses to be recognized in the quarter in which they are incurred. To reduce this adverse impact on operating expenses, managers at Symbol made improper topside journal entries to reclassify some of the ordinary performance bonuses. Managers reclassified the ordinary performance bonuses as nonrecurring bonuses related to the corporate acquisition, which are excluded from operating expenses. Such actions significantly inflated net earnings for the related quarter.

Finally, in order to manipulate the gross profit margin that managers reported for the related year, managers at Symbol reclassified numerous expenses from cost of goods sold to operating expenses through the misuse of topside journal entries. Such actions artificially boosted gross profit margin and enabled managers at Symbol to conceal that a recent drop in prices had eroded sales profits.

PREVENTATIVE MEASURES

As is evident in the two cases involving Cendant and Symbol, the fraudulent misuse of topside journal entries has been an alarming trend in recent years. This trend raises questions concerning the ability of auditors to detect such fraudulent activity. In the cases of Cendant and Symbol, very weak internal controls were in place. Therefore, auditors must ensure the existence and implementation of strong internal controls by company management.

For instance, auditors should check for the existence of an internal audit department and should communicate regularly with those associated with the internal audit. Auditors should see that managers monitor and require authorization for all journal entries as well. Journal entries should be adequately supported and should accurately reflect the underlying events and transactions. Furthermore, auditors should familiarize themselves with company procedural manuals and make certain that managers enforce strict adherence to the procedures outlined in these manuals. Finally, auditors should take into account the process by which an entity prepares its financial statements and should ensure that proper controls are present in this process. Although collusion among managers can impede auditors' ability to detect fraudulent misuse of topside journal entries, management's failure to implement strong internal controls can often signal fraudulent activity.

Aside from verifying that certain controls exist from management's perspective, auditors should make sure that they demonstrate a high degree of professional skepticism in their own work. They should design audits to closely examine irregular adjustments

and journal entries, particularly topside journal entries that seem to have no basis in GAAP (topside journal entries involving reserve accounts are frequent red flags). Auditors should also compare revenues and expenses from previous accounting periods and note any sizeable differences between amounts from period to period. When selecting items to test, auditors should identify the population of journal entries and adjustments that affect financial statements. Finally, auditors should be conscious of management's expectations and be particularly skeptical if managers are under intense pressure to obtain lofty financial results.

REESTABLISHMENT OF PROFESSION

The accounting frauds of the last decade have damaged the reputation of what was once a highly trusted profession. Managers now must realize the importance of auditors in maintaining the credibility and reputation of their respective companies. Auditors must also realize the importance of their responsibility to ensure the credibility of both the clients they audit and the auditing profession itself. The fraudulent misuse of topside journal entries has become a huge problem in recent years, and it demands the attention of both managers and auditors alike. Although not all topside journal entries are fraudulent, managers, and particularly auditors, should be keenly aware of all topside journal entries and examine them closely. By paying closer attention to the use of topside journal entries, both managers and auditors can contribute to the reestablishment of character and trust that was once prevalent in the accounting profession.

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