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Ten things about bankruptcy and fraud

A review of bankruptcy filings

Deloitte Forensic Center
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Ten things about bankruptcy and fraud:

Some of the largest companies ever to file for bankruptcy, such as Enron and WorldCom, were later found to have had management engaged in large-scale, complex fraud schemes. The failures of these and other companies, due in large part to fraud, led to more stringent federal legislation such as the Sarbanes-Oxley Act of 2002 and increased enforcement efforts by the SEC. Despite the stricter legal and regulatory environments, company failures due to fraud remain a public concern.

In the past few years, many companies, troubled or not, have created highly-leveraged balance sheets with many layers of debt. When such a highly-leveraged company files for bankruptcy protection, its creditors may have little other recourse than to seek recovery from non-traditional sources such as challenging potentially fraudulent conveyances, seeking recovery under D&O policies, and filing other (non-bankruptcy) litigation. This strategic shift has raised risks for directors, officers, and senior management and increased the importance of fraud detection.

Is fraud more prevalent in troubled companies than in healthy companies? What types of fraud are more common in companies that file bankruptcy, and which industries are prone to both bankruptcy and fraud? In particular, what are the recent trends of bankruptcy filings by companies identified in SEC fraud-based enforcement actions?

To address these questions, the Deloitte Forensic Center and Deloitte's Reorganization Services group analyzed bankruptcy filings between 2000 and 2005, and SEC enforcement releases issued from 2000 through 2007. This booklet provides snapshots of data from the SEC's enforcement releases relating to alleged frauds, bankruptcy filings, and non-bankrupt public companies.

This study may be useful to various constituents in the bankruptcy process as they begin to understand some risks of fraud in troubled companies and start thinking about protecting their interests. In addition, these findings highlight some of the risks of company failures, particularly in industries and types of companies that may be prone to fraud.

Methodology

Bankruptcy filings

The researchers of this study reviewed the bankruptcy filings of 1,009 publicly-traded companies that filed for chapter 11 bankruptcy protection between January 1, 2000, and December 31, 2005 (the “Investigation Period”). Companies that reported annual revenues of less than \$100 million for the fiscal year that immediately preceded the bankruptcy filing were then removed from the list. The resulting population of 519 companies (the “Bankrupt Companies”) served as the study group in this analysis.

Bankruptcy data came from Bankruptcydata.com and revenue data came from either Capital IQ or Bankruptcydata.com.

Non-bankrupt companies:

The researchers identified 3,163 companies that were publicly traded (as of June 2008) and had reported revenues of at least \$100 million during at least one fiscal year during the Investigation Period.

Of the 3,163 companies identified, 212 also qualified as Bankrupt Companies as described above, while an additional 32 companies filed for bankruptcy protection between January 1, 2006, and May 31, 2008 (after the Investigation Period). These 244 bankrupt companies were then removed from the population, resulting in a control group (the “Non-Bankrupt Companies”) consisting of 2,919 public, non-bankrupt companies with revenue of at least \$100 million for at least one fiscal year during the Investigation Period.

Revenue data came from Capital IQ.

AAERs

The SEC reports administrative enforcement actions taken against SEC registrants through Accounting and Auditing Enforcement Releases (AAERs). The AAERs issued from January 1, 2000, through December 31, 2007 were reviewed (note: this period is two years longer than the Investigation Period, although all of the AAERs dealt with activities that occurred before the bankruptcy filings). For the analysis, only final AAERs that alleged financial statement fraud, excluding releases that dealt solely with auditors, among others were considered. This filtering process resulted in a population of 383 AAERs issued to 352 unique companies. Of these 352 companies, 48 qualified as Bankrupt Companies and 91 as Non-Bankrupt Companies, as defined above.

This filtering process resulted in a subset of 139 companies that were issued AAERs and had revenue of \$100 million for at least one year during the Investigation Period or during the fiscal year immediately preceding their bankruptcy. None of the remaining 471 Bankrupt Companies, and none of the remaining 2,828 Non-Bankrupt Companies, were issued an AAER by the SEC during the relevant time period.

The companies that received AAERs were categorized into nine industries for this study:

- Aviation and transport services
- Consumer business
- Energy and resources
- Financial services
- Life sciences and health care
- Manufacturing
- Public sector
- Real estate
- Technology, media, and telecommunications (TMT)

AAERs often describe more than one fraud scheme active in a company during a given period. Accordingly, 12 categories were used to classify the nature of the fraud alleged in the AAERs:

- Aiding and abetting
- Asset misappropriation
- Bribery and kickbacks
- Goodwill
- Improper disclosures
- Investments
- Manipulation of accounts receivable (A/R)
- Manipulation of assets
- Manipulation of expenses
- Manipulation of liabilities
- Manipulation of reserves
- Revenue recognition

For each AAER, the date of the final release and, importantly, the earliest date of evidence of each fraud scheme were captured.

Where is there more fraud? Among Bankrupt Companies or Non-Bankrupt Companies?

Chart 1a: Financial-statement-fraud AAERs issued by SEC to Bankrupt Companies (public companies with revenue > \$100M)

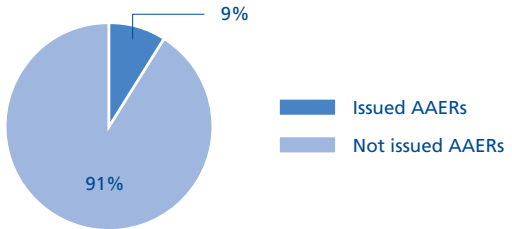
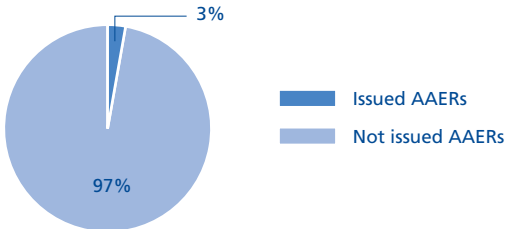


Chart 1b: Financial-statement-fraud AAERs issued by SEC to Non-Bankrupt Companies (public companies with revenue > \$100M)



- Bankrupt Companies were three times more likely than Non-Bankrupt Companies to be issued financial-statement-fraud AAERs by the SEC.
- Of 519 Bankrupt Companies, 48 (or 9%) were issued AAERs by the SEC.
- Of 2,919 Non-Bankrupt Companies, 91 (or 3%) were issued AAERs by the SEC.

Are companies charged with fraud more — or less — likely to file for bankruptcy than those not charged?

Chart 2a: Bankruptcy filings by companies issued AAERs (public companies with revenue > \$100M)

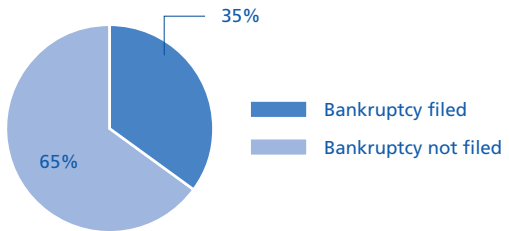
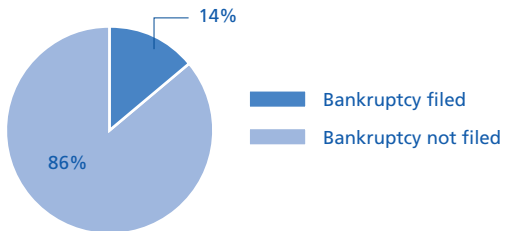


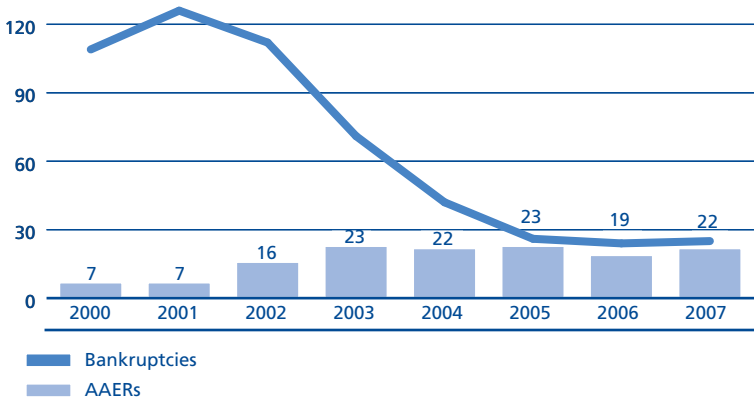
Chart 2b: Bankruptcy filings by companies not issued AAERs (public companies with revenue > \$100M)



- Companies issued financial-statement-fraud AAERs were more than twice as likely to file bankruptcy as those not issued one.
- Of 139 publicly traded companies with revenue greater than \$100 million that were issued AAERs, 48 (or 35%) filed for bankruptcy during the Investigation Period.
- Of 3,299 publicly traded companies with revenue greater than \$100 million that were not issued AAERs, only 471 (or 14%) filed for bankruptcy during the Investigation Period.

Is the SEC identifying more fraud? Are public companies filing fewer bankruptcies?

Chart 3: Bankruptcy filings and AAERs issued by the SEC (public companies with revenue > \$100M)



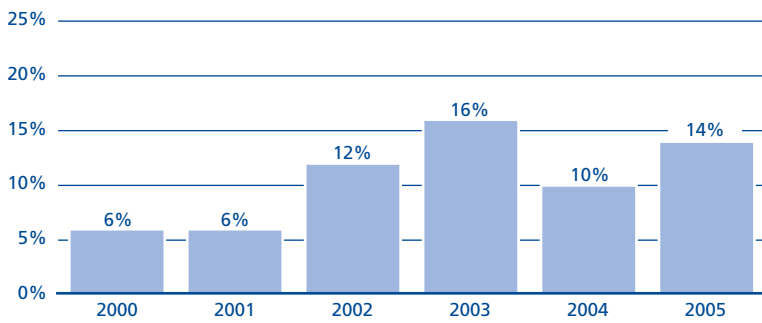
In cases of multiple bankruptcy filings by the same company or multiple AAERs issued to the same company, this data includes only the first bankruptcy filing or the first AAER issued.

- Bankruptcy filings trended sharply downward since peaking in 2001, though fraud-related AAERs issued tripled.
- Bankruptcy filings in the U.S. by publicly traded companies with revenue of more than \$100 million peaked in 2001, at 126, then dropped to near 25 annually since 2005.
- From 2000 through 2007, the SEC issued financial-statement-fraud AAERs (relating to activities that occurred before bankruptcy filings) to 352 registrants. Of these, 139 related to public companies¹ with revenue in excess of \$100 million; 91 were Non Bankrupt companies and 48 were Bankrupt companies.
- AAERs issued by the SEC to public companies jumped in 2002 and have stayed near 20 since 2003.

¹Publicly traded company as of June, 2008 or public company that filed for bankruptcy during the Investigation Period.

Is fraud rising in Bankrupt Companies?

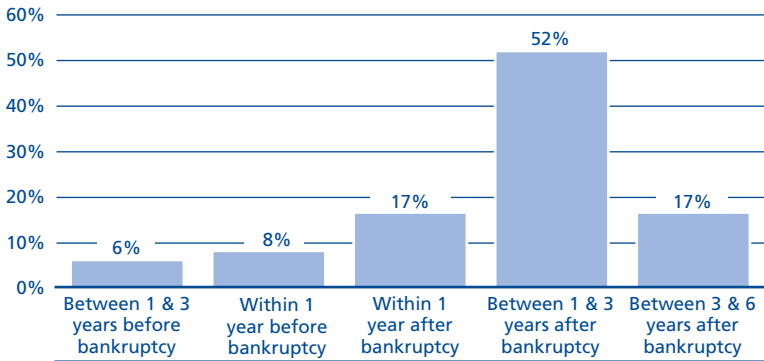
Chart 4: Percentage of Bankrupt Companies issued AAERs by the SEC



- The percentage of Bankrupt Companies issued financial-statement-fraud AAERs doubled between 2001 and 2002 and has stayed at or above 10% since then.
- Of the Bankrupt Companies that filed chapter 11 in 2003, 16% were issued AAERs — the highest percentage so far this decade.
- In response to major corporate and accounting scandals, including the failures of Enron and WorldCom, Congress enacted the Sarbanes-Oxley Act in mid-2002. AAER issuances to the Bankrupt Companies increased significantly after that.

Is the SEC charging fraud an early warning signal for bankruptcy?

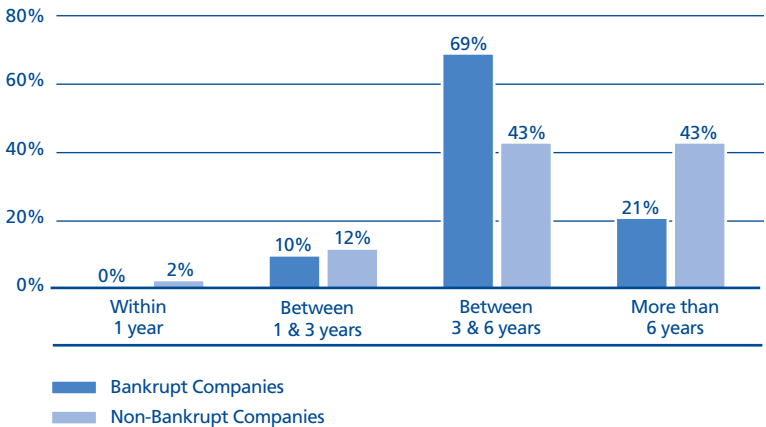
Chart 5: Time lag between bankruptcy filing and issuance of AAER



- As one would expect, when a large publicly traded company files for bankruptcy, the event attracts the SEC's attention. Allowing for some period of administrative delay, it is not surprising that the SEC issued by far its greatest number of AAERs (69%) within three years after such companies filed for bankruptcy.
- Fewer than one in seven (14%) AAERs were issued before the companies filed for bankruptcy. Although this is a small proportion, these situations may provide a warning signal of a potential bankruptcy filing.
- Since the Sarbanes-Oxley Act took effect in mid-2002, the average time between bankruptcy filing and the issuance of AAERs decreased by 25%, from approximately two years to 1.5 years.

Is the time lag between the commission of a fraud and SEC charging of fraud shorter for Bankrupt Companies?

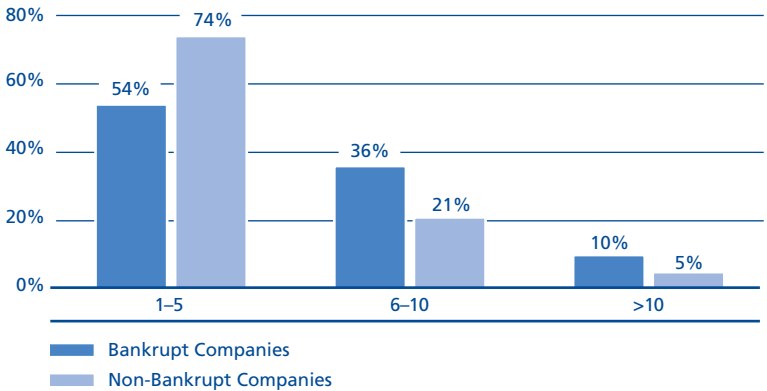
Chart 6: Time lag between commission of fraud scheme and issuance of AAER



- The average time lag between the commission of a fraud scheme and issuance of an AAER was 5.8 years.
- The average time lag between the commission of a fraud scheme and the issuance of an AAER was shorter for Bankrupt Companies (five years) than for Non-Bankrupt Companies (six years).

Do Bankrupt Companies' employees engage in more fraud schemes than Non-Bankrupt Companies' employees?

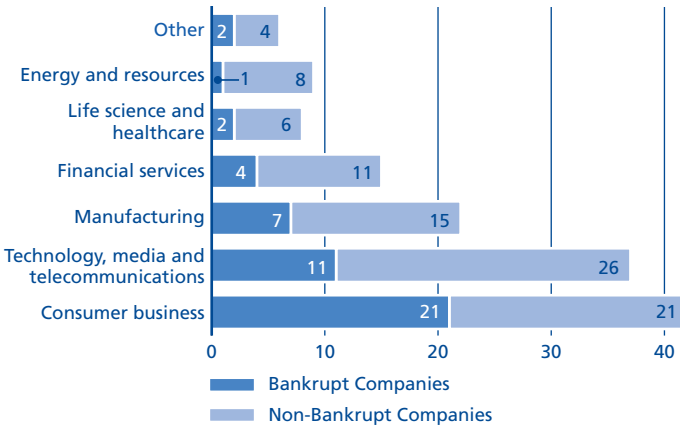
Chart 7: Number of fraud schemes in Bankrupt vs. Non-Bankrupt Companies (among companies issued AAERs)



- Bankrupt Companies were twice as likely as Non-Bankrupt Companies to have more than 10 fraud schemes in their history — and at least 1.5 times as likely to have six to ten fraud schemes as Non-Bankrupt Companies.
- Bankrupt Companies with revenue greater than \$10 billion had 10.8 fraud schemes on average, while those with revenue between \$100 million and \$10 billion had 4.3 fraud schemes on average.

Which industry is likely to have more bankruptcy filings and frauds?

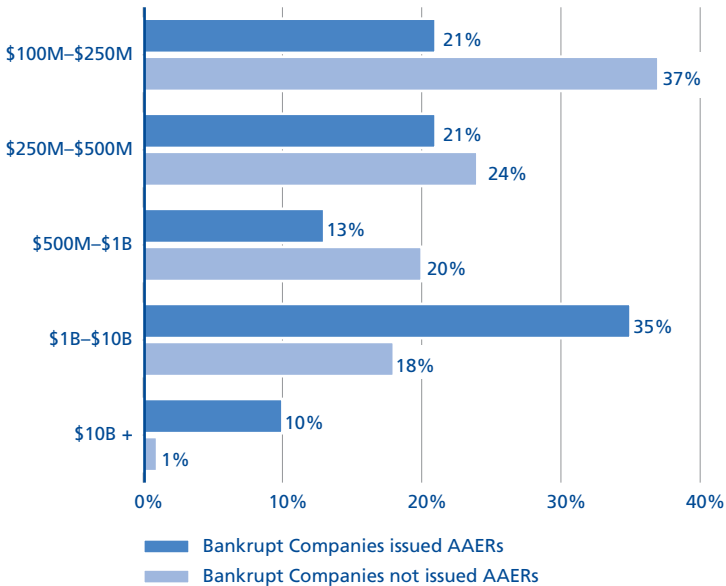
Chart 8: Industry classification of companies issued AAERs for Bankrupt vs. Non-Bankrupt Companies



- The largest proportion (30%) of companies issued AAERs was in the consumer business sector. Of 42 consumer business companies that received AAERs, 21 (or 50%) filed for chapter 11.
- The next largest proportion (27%) of companies issued AAERs was in the TMT sector. Of 37 TMT companies that received AAERs, 11 (or 30%) filed for chapter 11.
- Of nine energy and resources companies issued AAERs, only one or (11%) filed for chapter 11.

Is there a correlation between revenue size and fraud among Bankrupt Companies?

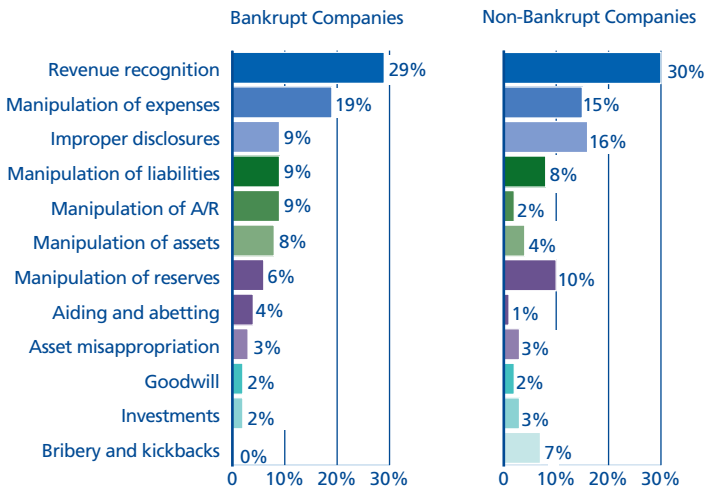
Chart 9: Revenues of Bankrupt Companies issued AAERs vs. those not issued AAERs



- Thirty-five percent of Bankrupt Companies issued AAERs had \$1–10 billion in revenue the year before filing.
- Among Bankrupt Companies, the average revenue was higher for those issued AAERs (\$5.3 billion) than for those not issued AAERs (\$870 million).
- Among Bankrupt Companies with revenue greater than \$1 billion, 22 (or 25%) were issued AAERs by the SEC. In contrast, only 9% of Bankrupt Companies with revenue greater than \$100 million were issued AAERs by the SEC.

Are fraud types charged by the SEC different for Bankrupt Companies from those for Non-Bankrupt Companies?

Chart 10: Fraud frequency, by type in Bankrupt vs. Non-Bankrupt Companies



- Revenue recognition is by far the most common fraud issue for both Bankrupt and Non-Bankrupt Companies issued AAERs by the SEC.
- The second most common type of fraud for Bankrupt Companies was manipulation of expenses, at 19%, improper disclosures, at 16%, is the second most common fraud type for Non-Bankrupt Companies.
- Revenue recognition was most prevalent in the TMT industry (46% of all revenue recognition frauds were in TMT industry), while manipulation of expenses was most prevalent in the consumer business industry (half of all manipulation of expense frauds were in consumer business industry).
- The top three common types of fraud — revenue recognition, improper disclosures, and manipulation of expenses constitute 57% and 61% of all fraud types for Bankrupt and Non-Bankrupt Companies respectively.

Deloitte Forensic Center

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The Center aims to advance the state of thinking in areas such as fraud and corruption by exploring issues from the perspective of forensic accountants, corporate leaders, and other professionals involved in forensic matters.

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Reorganization Services include:

- Bankruptcy Administration Services
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- Debtor Advisory
- Examiner Services
- Fresh Start Accounting
- Intermediary Advisory
- Lender Advisory

This study was conducted by the Deloitte Forensic Center and by Deloitte's Reorganization Services group.

Deloitte Forensic Center

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- ForThoughts newsletters and videos:
 - Mitigating risk: A focus on financial statement fraud
 - “Fraud Control Gap” implications for companies
 - Monitoring hospital-physician contractual arrangements to comply with changing regulations
 - Some of the leading practices in FCPA [Foreign Corrupt Practices Act] compliance
 - The shifting landscape of health care fraud and regulatory compliance
 - Avoiding FCPA risk while doing business in China
 - Helping to Prevent University Fraud
- Deloitte Forensic Center booklets:
 - Ten things about financial statement fraud
 - Ten things about fraud control
 - Ten things about financial statement fraud — second edition
 - Ten things about the consequences of financial statement fraud
 - Ten things about bankruptcy and fraud

More information on the findings of this study can be found at
www.deloitte.com/forensiccenter.

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