

# First Friday Fraud Facts+

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## QUESTIONS OR COMMENTS:

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Inside this issue:

Welcome	1
Form 10-Q	1
Form 10-K	1
Evaluating Reports	2
Fraud Case	2

*The Idaho State Controller's Office distributes this newsletter as a cost-effective method of increasing awareness about ways to detect and prevent fraud, waste, and abuse in government.*

Welcome to First Friday Fraud Facts+ (F4+). This edition will discuss document fraud.

Publicly traded companies are required to disclose information on a regular basis to educate investors about their financial condition.

### Form 10-Q

Companies that issue stock or bonds on a publicly traded market are required by the Securities and Exchange Commission (SEC) to file quarterly financial reports, the Form 10-Q. These quarterly reports are not audited, and in addition to financial information, contain other relevant data regarding the company's ongoing operations. The information contained must be free of material misstatements so investors have a clear picture of the company's well-being.

The quarterly reports are filed at the end of each of the first three quarters of the company's fiscal year, generally within 40 days of the end of the quarter.<sup>1</sup>

### Form 10-K

The SEC also requires publicly traded companies to submit an annual report, the Form 10-K, generally within 75 days of fiscal year-end. All 10-Ks are available on the SEC's website.<sup>2</sup> This report contains four parts:

#### Part I

- Descriptions of the company's business, products and services, subsidiaries and markets in which it competes;
- Risk factors the company may face;
- Unresolved Staff (SEC) Comments; and
- Properties held.

#### Part II

- Equity information, number of shareholders, dividends, and stock repurchases;
- Selected financial data for the last five years;
- Management's discussion and analysis of financial condition and results of operations, including risks the company faces;
- Quantitative and qualitative disclosures about market risk;



- Changes in and disagreements with accountants on disclosure;
- Controls and procedures; and
- Other information.

#### Part III

- Directors, executive officers, and corporate governance;
- Executive compensation;
- Information about the shares owned by the company's directors, officers, and large shareholders;
- Related party transactions and director independence; and
- Principal accountant fees and services.

#### Part IV

- Financial statements
- Bylaws
- Material contracts
- Subsidiaries

The 10-K is a comprehensive report and companies are prohibited from making materially false or misleading statements in these reports. Omitting material information is also prohibited, as omission of relevant data might lead an investor to an incorrect conclusion. The company's CEO and CFO must certify to the accuracy of the 10-K.<sup>3</sup>

### Evaluating Reports

By issuing quarterly and annual reports, a company is providing information to investors and other stakeholders about the health of the business. Financial reports are required to be prepared according to Generally Accepted Accounting Principles, or GAAP. These principles ensure consistency and comparability between companies and conformance with regulations.

The financial statements are required to be audited by an independent accountant. The accountant issues an opinion on whether or not the financial statements fairly present the company's financial position in conformity with GAAP. A qualified opinion indicates the auditor has reservations about some part of the report and should be a red flag for investors.

### Fraud Case

Assisted Living Concepts, Inc. (ALC) was a senior residence provider with headquarters in Wisconsin. Between 2008 and 2012, ALC operated more than 200 senior residences in the United States, consisting of more than 9,000 units. Annual revenues during this period ranged from \$225 million to \$234 million. ALC employed about 4,200 people, about 200 of them working at corporate headquarters or regional offices.

In 2008, ALC entered into a lease agreement to operate facilities in Alabama, Florida, Georgia, and South Carolina, comprising some 540

units. The agreement had specific occupancy and cash flow requirements. A drop in occupancy would create a drop in revenues, or cash flow.

If ALC did not meet the lease provisions, the landlord could terminate the lease, evict ALC from all eight facilities, and require ALC to pay an amount equal to the unpaid rent for the remainder of the lease. Based on actual occupancy rates, the total unpaid rent for 2009 through 2011 would have amounted to \$62.5 million and represented an average of 76 percent of ALC's income from operations during this time, clearly significant.

ALC's CEO, Laurie Bebo, and CFO, John Buono, realized within a year of signing the lease that ALC would not meet the occupancy requirements, although they failed to disclose this to the board of directors. When employees travelled to the leased facilities as part of their job, they were directed to stay at the facility instead of a hotel. Bebo and Buono began including between 45 and 103 employees and other non-residents as occupants when calculating the occupancy rate. Revenue was similarly inflated to correspond with the fraudulent occupants.

To perpetuate the fraud, ALC's Forms 10-K and 10-Q were also falsified. When ALC should have reported the possibility of defaulting on the lease, this disclosure was omitted. Bebo and Buono also certified the Forms 10-K and 10-Q were materially correct. Ultimately, the landlord discovered the fraud and sued for damages. To settle the lawsuit, ALC purchased the eight properties for \$37.2 million more than the appraised value, expensing the loss, and wrote off an additional \$8.96 million related to the scheme.

Buono has been barred from issuing securities and practicing as an accountant and fined \$100,000.<sup>4</sup>

<sup>1</sup> Form 10-Q. <http://www.sec.gov/answers/form10q.htm>. Accessed February 5, 2015.

<sup>2</sup> Form 10-K. <http://www.sec.gov/answers/form10k.htm>. Accessed February 5, 2015.

<sup>3</sup> How to Read a 10-K. <http://www.sec.gov/answers/reada10k.htm>. Accessed February 5, 2015.

<sup>4</sup> In the Matter of Laurie Bebo, and John Buono, CPA, Respondents. <http://www.sec.gov/litigation/admin.shtml>. See 2015, First Quarter, Release No. 34-74177, Jan. 29, 2015. Accessed February 5, 2015.

