

Case 1 – Hamilton Corporation

Overview

Hamilton Corporation (the Company) is a multinational auto parts supplier headquartered in the Midwest. Hamilton began its operations as a wholly owned subsidiary of Motor Company (MC), and was ultimately spun off and incorporated in 1999. Shortly after the separation, MC informed Hamilton that the Company owed an estimated \$350 to \$800 million in warranty claims related to automotive sales that had occurred prior to the separation in 1999. Hamilton's management team believed that any warranty claims related to sales prior to the separation should be limited to the reserve amount that was agreed to at the time of separation. However, because MC remained Hamilton's largest client, the management team was motivated to find a solution that would appease MC.

As a direct result, the management team at Hamilton worked hard to convince MC to cap warranty claims related to prior automotive sales at \$100 million. Unfortunately, MC rejected the idea and instead continued to assert the full warranty claim against Hamilton. Recognizing that the Company could not afford to make warranty payments in excess of \$100 million without a significant reduction in operating income, management had significant incentives to mask the true level of warranty expense in order to meet analysts' forecasts.

Damaged Goods

The management team at Hamilton fully understood that the Company's performance in its first several quarters was vital to the long-term success of the Company. Because the marketplace often views spin-offs as "damaged goods" in the early stages, the demonstration of impressive financial results, right away, was believed to be imperative to the Company's ability to raise future capital.

Management quickly realized that a series of challenges existed that were likely to prevent the Company from reporting favorable results in its first several quarters of operation as a stand-alone entity. To start, management believed that the warranty claims asserted by MC had the potential to cripple the Company. In addition, management had to address a sharp and unexpected drop in automotive demand that affected its sales volume during the same time period. Unwilling to report adverse results and risk the Company's ability to continue as a going concern, management made the decision to report favorable results, no matter what.

Warranty Claims

Faced with mounting pressure from the warranty claims asserted by MC, management increased Hamilton's warranty reserve by \$112 million during the second quarter of 2000. The increase in warranty reserve should have been charged as an expense under GAAP since the company Hamilton did not have a written agreement stating that the claims reflected a correction to its 1999 spin-off agreement with MC. However, in an effort to limit the effect on reported net income, management booked the entry directly to retained earnings as a net adjustment to the spin-off transaction. In so doing, management failed to reveal the true nature of the charge to investors.

As deliberations with MC continued throughout 2000, Hamilton eventually agreed to settle 27 warranty claims for a total of \$237 million in the third quarter. Recognizing that another spin-off related adjustment to retained earnings might raise a red flag, management developed a more elaborate accounting scheme to mitigate the effects of the additional warranty claims on net income. To do so, management decided to focus on the subjectivity that existed in the determination of pension expense. More specifically, management determined that if it revised assumptions used in determining pension expenses prior to the spin-off, the payment to MC could be disguised primarily as a "true-up" of the pension liability.

To support this scheme, management obtained a letter from the Company's actuary that provided the "reasonable range" for pension assumptions that had been made in the past. Management then deliberately selected a new point estimate within each range to make it appear that the Company actually owed MC \$202 million for its past pension liabilities. Additionally, management convinced MC to allow the meeting minutes between the two companies to reflect an erroneous discussion

of past pension estimates to further support the unfounded pension loss claim. As a result, management was able to book \$202 of the \$237 million warranty settlement as an actuarial loss in its pension plan. Only the remaining \$35 million was recognized as additional warranty expense in the financial statements.

Off-Balance Sheet Financing

As the end of 2000 was drawing near, management decided to take additional actions to boost reported earnings. Specifically, Hamilton devised a scheme to remove \$200 million of high-value precious metals inventory (used in the production of auto parts) from the balance sheet through a collateralized loan agreement with Culpepper Bank late in 2000. According to the agreement, which was deliberately designed to mislead balance sheet readers, Hamilton would receive the cash proceeds of the sale, but was then required to buy the inventory back from the bank 30 days later for the original purchase price plus \$3.5 million in interest. Prior to executing the agreement, Hamilton's auditor advised the Company that the transaction could **only** be accounted for as a sale and repurchase under GAAP if both prices were based on market, and the transaction costs did not include Culpepper Bank's interest costs. Hamilton agreed to the conditions set forth by the auditor and then made sure that the form of the transaction would meet the auditor's conditions.

To convince the auditor that the financing transaction qualified as a sales and repurchase agreement under GAAP, management created false documents including a memo that provided Hamilton's rationale for the below market prices for the sale of inventory under the agreement. The memo stated that the below market prices were supported by large volume discounts and one-month future prices of metals – neither of which were justified by the actual market data. However, the analysis was elaborate and management convinced the auditors that the transaction qualified as a sale and repurchase agreement under GAAP. Almost concurrently, Hamilton's management used a very similar strategy to remove an additional \$70 million of batteries and generators from its reported inventory balance. Since Hamilton used LIFO, each of these liquidating transactions allowed Hamilton to artificially boost net income with LIFO liquidation gains that were improperly realized under GAAP with the sale and repurchase transactions.

Fraud Discovery

Initially, management overstated net income by \$69 million in booking the warranty claims adjustment to retained earnings and then improperly increased net income by an additional \$130 million through its treatment of the subsequent warranty claims settlements with MC. In addition, due to the LIFO gains realized with the fourth quarter inventory transactions, Hamilton recognized an additional \$81 million dollars to its bottom line. Taken together, the misstatement totaled approximately \$280 million dollars in 2000.

As noted, management's financial statement fraud was not limited to a single transaction. Rather each time that pressure existed to meet market expectations, management appeared to devise a scheme to boost net income. The schemes were supported by skillfully crafted evidence provided to the auditor by the management team. In the end, it was a whistleblower, believed to be from a vendor involved in a fraudulent transaction, which objected to the Company's inaccurate reporting of a specific transaction that turned management into the SEC. The ensuing SEC investigation uncovered the full extent of management's wrongdoings over a four-year period of time.

Case Questions

- 1. Based on your understanding of fraud risk assessment and the case information, identify at least three specific fraud risk factors related to Hamilton Company.**
- 2. If you were responsible for planning the audit of Hamilton Company, how would the fraud risk factors identified in question #1 have influenced the nature, timing, and extent of your audit work?**

3. Please consider the five steps of the KPMG Judgment Framework. For each step, think carefully about what the auditors could have done to help detect the fraudulent activity related to the *warranty reserve* account at Hamilton Company. Please use the following questions to guide your critical thinking about this case:
 - a) Clarify the issues and the objectives related to auditing the warranty reserve account at Hamilton. To do so, please ask yourself what specific problem needs to be solved by the auditor? What assumptions would have the biggest impact on the overall judgment to be made? How does this judgment relate to the overall audit process?
 - b) Consider the various alternatives that should be thought about when auditing the warranty reserve account at Hamilton. To do so, please ask yourself about each of the alternatives that are reasonably possible, even when they might contradict the client's point of view. Are there any external factors that should be considered?
 - c) Consider the type of information and evidence that should be gathered when completing the audit of the internal control activities related to the warranty reserve account at Hamilton. To do so, please ask yourself about the type of information that would be helpful to determine whether the internal control activities were operating effectively. How can you be sure that the information gathered is reliable? In addition, how can you be sure that the evidence is appropriate in this situation? Finally, what evidence could be gathered that might reveal that the internal controls were NOT operating effectively?
 - d) Consider the type of information and evidence that should be gathered when completing the substantive testing procedures related to the warranty reserve account at Hamilton. To do so, please ask yourself about the type of information that would be helpful to determine whether the warranty reserve account was fairly stated in the financial statements. How can you be sure that the information is reliable? In addition, how can you be sure that the evidence is appropriate in this situation? Finally, what evidence could be gathered that might disconfirm your belief that the warranty reserve account was fairly stated?
 - e) Consider the factors that would have to be thought about when reaching a final conclusion about the warranty account at Hamilton. Although you do not have access to the actual evidence, what "big picture" issues would have to be thought about before reaching a final conclusion? Finally, what could possibly go wrong in this situation?
 - f) Consider the importance of documenting the rationale for your final conclusion. Why do you think it is important to document your rationale when finalizing your judgment? In addition, describe what is expected to be documented to support an auditor's professional judgment.
4. Describe the availability tendency in your own words, and give an example of how the tendency could result in a lack of audit effectiveness. How can the tendency be mitigated?
5. Describe the confirmation tendency in your own words, and give an example of how the tendency could result in a lack of audit effectiveness. How can the tendency be mitigated?
6. Describe the overconfidence bias in your own words, and give an example of how the bias could result in a lack of audit effectiveness. How can the bias be mitigated?
7. Describe the anchoring bias in your own words, and give an example of how the bias could result in a lack of audit effectiveness. How can the bias be mitigated?
8. What tendency or bias is most likely to have manifested in the Hamilton case example? Please provide support for your answer.

About the Author

This case study was written by Jay C. Thibodeau (Bentley University) in collaboration and with support from colleagues at KPMG LLP to help audit instructors integrate the KPMG Professional Judgment Framework into the classroom. This case was based upon an Accounting and Auditing Enforcement Release (AAER) that was issued by the SEC in the recent past. The material is intended to be used for academic purposes only. The work of Denise R. Hanes (Villanova University) was instrumental in the completion of this case study and is gratefully acknowledged.
