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Caterpillar's Tax and Financial Statement Fraud

Over the years, there have been cases of fraudulent financial statement reporting. These intentional misrepresentations of the actual financial position of an organization have led to the closure of so many businesses that were initially doing well. The misstatement can take the shape of falsification of underlying accounting records, intentionally ignoring the accounting guideline standards, deliberately omitting transactions or required disclosures in the financial statements. Hence, deliberate misrepresentation of material facts of an entity's financial position is a primary concern for investor and capital market stakeholders globally. Through this analysis, the paper will focus on Caterpillar Inc. as a case study of financial statement fraud that happened in 2013.

Caterpillar Inc. has been shrouded in allegations of accounting fraud for almost five years. According to a government-commissioned report, the heavy equipment maker has been evading to pay taxes by manipulating its financial statements from as far as 2013. Further reports indicate that the company has in many occasions failed to present a number of crucial paperwork related to exports in the past few fiscal years and that investigators discovered differences between what the company filed and what it forwarded to the government in the wake of investigations (Drucker 1).

The alarm was raised by Daniel Schlicksup, who had been serving in the company's accounting department for sixteen years. Apparently, Mr. Schlicksup had been informing company managers that the firm was involved in overseas tax evasion, but they did not heed his warnings. The scheme is believed to have aided the organization to illegally evade in excess of $1 billion in taxes. Mr. Schlicksup further supplied a volume of documents to the government to support his claims. In some of the evidence, he argued that the company in collusion with its auditing partner, PricewaterCoopers, had found a way to channel billions in revenues to Switzerland to evade taxes in America. With the help of the information provided by the whistleblower, the Internal Revenue Service (IRS) established in 2013 that the organization had engaged in accounting fraud and consequently demanded $2 billion in penalties and tax arrears (Gruley et al. 1).

Analysis of company statements

Legal proceedings

A scrutiny of the company's 10-k report between the financial years ending between 2010 and 2008 in relation to legal proceedings shows that the company faced some legal suits but they were not related to the above scandal. According to the 2010 report, the company acknowledged that it had unsettled legal issues associated with the manufacture, product design, intellectual property rights, contracts, performance liability, and employment issues. Additionally, litigation over environmental damage caused by Caterpillar's equipment has been mentioned in the report. The same legal actions are repeated for the financial year ending in 2009 and 2008. From these reports, it appears that the authorities had not suspected the firm to have been engaging in accounting fraud to prompt legal proceedings against the company (SEC 21).

Controls and procedures

Given that cases of tax fraud or evasion could be easily detected if a company has an effective control system, it is crucial to dig into Caterpillar's controls and procedures for the 3 years before the scandal was made public to unearth if the top executives had suspected any fraud, bearing in mind that the illegal tax regime had been in operation for over 10 years. In relation to this, the management acknowledged in its reports that it was responsible for creating and ensuring sufficient internal control over financial reporting. The reports for the fiscal years 2010, 2009, and 2008 further maintained that the firms' internal control was intended to offer a reasonable guarantee in relation to the true and fair view of the company's financial reporting and publishing of financial reports for public use in line with generally accepted accounting principles (GAAP). Based on this mandate, the company reported that through its chief executive officer and chief financial officer, it was satisfied that the internal controls were working effectively. Nevertheless, the organization gave an exemption clause which stated that due to the embedded shortfalls, internal controls over financial reporting can sometimes not detect or prevent fraud or misstatements (SEC 24).

Ironically, whereas the company gave itself a good score with regards to internal controls, investigations allude to the fact that senior officials with the help of the auditing firm were responsible for the said accounting fraud. Unfortunately, such unethical and illegal practices are not uncommon in the corporate world, intended for personal gain. According to experts, employees may be tempted to falsify financial report if their bonuses depend on the revenue growth. Top executives may want to keep shareholders content by also manipulating financial records to give an impression of a company doing well financially. In the context of Caterpillar's fraud, it appears that the latter reason could have informed the fraudulent activities.

Ratio analysis

The analysis uses the relationship between different portions of the financial statements to determine the actual position and performance of the company. Analyzing financial statements is particularly important because, through their scrutiny, it is easier to identify financial statement fraud red flags. In this regard, some of the common red flags for accounting fraud include exponential growth or abnormal profitability when compared to other firms in the industry. In some cases, the company in question could be reporting back to back negative cash flows or failure to recognize positive cash flows despite reporting an increase in profits. Also, substantial transactions with associated parties should be a cause for alarm. In fact, the increased volume of transactions between Caterpillar's head office in the US and its branch in Switzerland was one of the key red flags for this scandal. Furthermore, red flags may take the form of a voluminous sale to shell firms, an abnormal rise in debtor analysis among other indicators (Pinkasovitch 1).

Considering that Caterpillar was involved in tax fraud and the fact that taxes largely affect the profitability of a company, it is, therefore, prudent to focus on the profitability ratio of Caterpillar Inc. for the fiscal years 2010, 2009, and 2008 to determine whether there were any red flags. This section will focus on some significant ratios such as profit margin, operating profit margin and net profit margin.

Profitability ratios

Margins and return ratios help the financial statement users especially investors and management to gauge the efficiency of the company regarding revenue against investments (Altman and Hotchkiss 2). Each margin ratio compares income with total revenues.

Gross profit margin = gross profit / total revenue

Year	Gross profit	Total revenue	Profit margin
2010	12,221	42,588	28.7%
2009	8,510	32,396	26.3%
2008	12,909	51,324	25.2%

Operating profit margin = operating profit/ total revenue

Year	Operating profit	Total revenue	Operating profit margin
2010	3,963	42,588	9.3%
2009	577	32,396	1.78%
2008	4,448	51,324	8.67%

Net profit margin = net profit / total revenue

Year	Net profit	Total revenue	Net profit margin
2010	2,700	42,588	6.3%
2009	895	32,396	2.7%
2008	3,557	51,324	6.9%

The profitability ratios for Caterpillar show an average performing company for the three-year period under review. Whereas the ratios are within the expected range, Caterpillar's performance appears to be higher than that of its competitors something which somehow suggests the possibility of fraudulent accounting practices.

From the above analysis, it is evident that financial statement fraud can take many shapes. For instance, many accounting scandals in the past such as that involving the Enron Corporation involved the inflation of revenues to give a false impression of the financial state of the company. Such types of fraud are common, but with the emergence of Caterpillar's scandal, it appears that mischievous executives are continuously finding crafty ways of manipulating financial reports for personal and corporate gain. Unluckily, detecting red flags can be a toll order sometimes, something evident in the analysis above as we did not find any trend that suggested engagement in financial statement fraud. Partly, this is because organizations engaged in financial manipulation always work to cover loopholes for discovery. Therefore, to unearth activities such as those engaged by Caterpillar I would suggest a holistic approach towards fraud detection. This includes offering good incentives to whistleblowers and employing in-depth analysis over the financial statements of those companies suspected to have committed financial statement fraud. For instance, comparative ratio analysis will go a long way in helping auditors and analysts to identify anomalies. By the use of ratios such as profitability ratios, and other mathematical techniques it can be easier to spot discrepancies. However, this approach faces challenges such as collusion between auditing companies and their clients to conceal the truth. To deal with this challenge it would be prudent for auditors and investigators to hold high standards of ethics and professionalism.

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Useful links

https://www.sec.gov/Archives/edgar/data/18230/000110465911008938/a10-18643_110k.htm#Item3_LegalProceedings__121638

https://www.sec.gov/Archives/edgar/data/18230/000001823010000092/form10k_2009.htm#item9

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