

# [An analysis of the financial implications of fraud on business failure; the case ...](https://assignbuster.com/an-analysis-of-the-financial-implications-of-fraud-on-business-failure-the-case-of-refco-inc-usa/)

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A.

Introduction This research report attempts to highlight the circumstances that led to the failure of Refco Inc. ; a New York based multinational commodities and forex brokerage firm. It focuses on the strategy deployed by the company’s executives in perpetrating fraudulent acts in misrepresenting the company’s financial accounts; the revelation therein have been described by many as one of the largest bankruptcy cases in the history of the United State’s financial services industry. A critical analysis of the principal methods used in falsifying the company’s financial statements is crucial in providing a clear picture of the role played by financial information in the failure of Refco Inc. Thus an introduction to the term “ Round Trip Loans” and its relevance in the Refco debacle is provided in the pages that follow in addition to a critique of the role of Refco’s finance team and its external auditors in the falsifications and cover-up. B.

Discussion & Analysis of Fraud and Loss at Refco Inc. B. 1 History of Refco Inc. Refco Inc. was founded in Chicago USA in 1969 by Ray Freidman and his Stepson, Thomas Dittmer.

The firm was christened Ray E. Freidman & Co. at inception but was renamed after its relocation to New York. Initially, investors appeared confident in the latency of the futures market and Freidman had gathered a sizable customer base to propel the company to a favorable start(Smith, 2005). By 1998, Dittmer left Refco and relinquished his responsibility as CEO to the then Chief Finance Officer of the company, Phillip Bennet during a period when the industry was faced with losses following the Asian currency crises and the Russian debt default.

Regardless, Refco steadily grew to eventually become one of the largest commodities and futures trading brokerage conglomerate in the United States. This was due largely to the return on investments to its hedge fund clients, amassing a customer base in excess of 200, 000 over the years on the one hand. On the flip side, the company had also garnered a history of regulatory sanctions and fines, but still managed in 2004 to attract prospective buyer Thomas H. Lee (THL) LLP, a renowned equity firm who eventually purchased Refco in a $450, 000, 000 leveraged arrangement and by 2005 introduced the stock of the “ new Refco” to the New York Stock Exchange (Russ, 2011). Refco Inc. , worth several billions of dollars operated in several other cities around the world including London, Paris, Singapore and Sydney.

B. 2 Refco’s Fraud ActivitiesRefco’s business models involved extending loans to customers thereby empowering them to trade and further re-invest in larger deals subsequently earning Refco commissions, revenues and profits. However the more the client base grew the more porous the credit-worthiness examinations became. This exposed the company to huge losses from defaulters. By October of 2005, barely two months after the Initial Public Offering of its common stock, a statement was issued by Refco that its CEO had fraudulently concealed a $430, 000, 000 liability (Wikipedia, 2011). The revelation of this scandal led to the immediate and panic mass withdrawal of deposits by customers, shareholders and creditors of the company.

Richard S. Miller, 2005 offered that at the climax of its short lifespan on the NYSE market, Refco stocks were traded at $30. 55per share and crashed to $0. 75 within a few days and was eventually delisted from the NYSE. The diagram below illustrates the trajectory of Refco’s shares from the date of its Initial Public Offer (IPO) to the suspension of the trading of its stocks.

The Economist, 2005) Refco’s management devised a scheme to erase the uncollectable receivables from the company’s reports by concealing the bad debts. They are converted to “ loans” and recorded as such; then transferred onto the books of a Refco subsidiary, Refco Group Holding Inc (RGHI), thereby parading the subsidiary as the debtor to its parent company. However, this did not solve the problem as the company was now faced with the risk of its net income being affected since the “ transaction” involved a related entity. According to(Hoschberg, 2007) the senior management perpetrated a series of undocumented fraudulent “ round trip loan” (RTL) transactions in time for the beginning of each financial reporting period in a bid to disguise the RGHI receivable from auditors and shareholders. The transactions involved “ loans” to an unaffiliated third party from yet another Refco subsidiary, Refco Capital Markets (RCM), which in turn simultaneously loaned the amount to RGHI which the latter would subsequently utilize in “ repaying” Refco Inc.

o that at the end of the financial reporting period, the bad debt would have vanished from Refco’s books and disguised as “ loans” to third party customers and shortly after the end of the financial reporting period the entire process would be reversed leaving Refco with the initial liability plus additional expenses on interests paid to the third party hedge funds for their role in facilitating the transactions. These transactions were largely made possible since Refco’s internal controls for financial reporting were greatly deficient, coupled with the fact that the industry was deficient in proper regulations, as some have criticized the insufficiency of rules and codes such as the Sarbanes- Oxley act which was signed into law by the George Bush Administration in order to prevent the occurrence of another “ Enron” disaster(J. Henderson, 2005). B.

3 Theoretical Analysis of the Refco FraudNed Hill and Steve Albrecht opined that perceived pressure, perceived opportunity and rationalization of actions are the three common characteristics of all frauds (Birchfield, 2004). They believed that management is heavily pressured by the likes of Wall Street to meet unachievable financial expectations and also since management is erroneously credited for company success during economically buoyant periods, pressure is mounted on these executives to meet or surpass expectations during sour periods. They also suggested that where business executives are entitled to a large quantity of company stocks, they are more likely to yield to pressure and commit fraud in order to ensure that their stock price remains on the rise and these characteristics were evident in the Refco case. For instance, Philip Bennet (CEO) owned almost 45% of Refco. As a result he was entitled to millions of dollars in dividends at the close of each financial period.

For example, he received a substantial portion of an $82, 000, 0000 dividends following the IPO of August 2005(Hoschberg, 2007, p. 9)]. Furthermore, Refco Inc had a long history of recurrent run-ins with industry regulators such as the Commodities and Futures Trading Commission and the National Futures Commission. Refco’s internal controls on financial reporting and closing of books were gravely porous affording its management the opportunity to continually perpetrate fraudulent transactions and release bogus financial statements to mislead regulatory bodies, auditors, customers and shareholders. This is regardless of the introduction of new industry codes of conducts, like the Sarbanes Oxley Act of 2002, to guide financial activities. These balance sheet gymnastics eventually resulted in the loss of millions of dollars.

Some have criticized the company’s external auditors, Grant Thornton and Arthur Anderson for not being able to detect and prevent such a monumental loss. Both renowned firms audited the company’s accounts at different stages between the late 1980s and year 2005(Hoschberg, 2007, pp. Exhibit 1, p. 2). Hochberg also found that the firms did not exhaustively carry out due diligence at various periods during their audit contracts with Refco and consequently failed to thoroughly investigate salient risks and establish that the company’s executives were prone to financial statements falsification. For example in a 2002 audit carried out by Arthur Anderson the financial statement held that the company had charged an unaffiliated party 22% on a purported loan to the customer.

Also during the audits by Grant Thornton, the frequency of the round trip loans which appeared in the company’s books ought to have raised suspicion and instigated further scrutiny. The firms however maintained that it is not within the auditor’s obligation to prevent the occurrence of fraud; nonetheless, they ought to have taken requisite steps to forestall further damage and prevent re-occurrences. C. Conclusion From the above, it is evident that the Refco case was characterized by a combination of variables/factors such as debt pressures, greed and demands to attain market and shareholder’s expectations. Refco showed signs of these traits in abundance, overlooking clear risks, nurturing greed and taking advantage of the porosity and laxity of internal controls and industry regulations. Since Refco was responsible for about $111billion volume on the forex market at the time of its economic failure ((Teanor, 2005), the consequence of these actions, amongst other things, posed a great risk to the global financial market.

Investors such as Rogers International Raw Materials Fund had to swallow a great financial loss since more than half of ts assets were tied-up in the scandal(Culver, 2005). Billions of dollars remain unrecoverable to customers, creditors and shareholders who have sought the intervention of the courts not to mention employees who lost their jobs following the wind-up of some of the company’s major operations. Following a similar disaster of Enron, this case further highlights the need for industry regulators and accounting professionals to be more vigilant in assessing related party transactions and instigate necessary action in order to forestall such avoidable and extensive financial losses. Bibliography Birchfield, R. (2004, September 6). Ethics; Fraud and the Family.

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