Case 1.5: Leslie Fay Companies

Introduction

Leslie Fay, a clothing company founded in 1947 by Fred Pomerantz, was a successful women's clothing manufacturer. Leslie Fay started out as a uniform manufacturer for women serving in the US Army during World War II. After the war, Fred Pomerantz decided to make use of his skills acquired creating uniforms and applied them to manufacture women's dresses. Mr. Pomerantz segmented his business in the women's clothing industry by developing dresses targeted towards women aged 30 through 55. Leslie Fay sold its manufactured dresses to large department's stores in major metropolitan areas which flourished after World War II. In 1952, Fred decided to take his company public on the stock exchange. During the 1960's two key players, who would play a major role in Leslie Fay's future, joined the company. First, in 1960, John Pomerantz, the youngest son of Fred Pomerantz, had recently graduated from Wharton with an economics degree and was hired. Later, in 1969, Fred hired Paul Polishan, a recent graduate attaining an accounting degree, who would later become the CFO and Senior Vice President of Finance as the company grew. By the late 1980's Leslie Fay was one of the largest manufacturers and suppliers of women's apparel. Some of Leslie Fay's competition included Donna Karen, Oscar de la Renta, Nicole Miller, Jones New York, and Alert Nippon. However, Liz Claiborne was one of Leslie Fay's closest competitors having larger annual sales than Leslie Fay. It was under John Pomerantz the company started to flourish even in daunting economical times.

After the death of Fred Pomerantz, John Pomerantz took over as CEO and through a leveraged buyout took the company private again. The buyout allowed John to later take the company public again and reap $40 million dollars in benefits from the new public offering. During his tenure as the CEO John Pomerantz and Paul Polishan were close allies. Paul used his skills and his friendship with John to rise through the ranks to become the CFO and Vice President of The Leslie Fay Corporation. John Pomerantz operated the business from the corporate head quarters located in downtown Manhattan while Paul was in charge of the accounting/finance offices 100 miles away in Wilkes-Barre, Pennsylvania. Paul Polishan was known as an autocrat who operated his office with a short leash. Donald Kenia the controller of Leslie Fay was second in charge at the offices in Wilkes-Barre; he was a soft spoken individual who liked to follow orders. Due to Donald Kenia's introverted character he was targeted by Leslie Fay executives when things turned sour for the corporation.

Problem

By the late 1980's, Leslie Fay was no longer manufacturing clothes that were cohesive with the new trend being followed by women in Leslie Fay's target. Women in the late 80's started to opt for casual attire, which was more comfortable, instead of the dresses manufactured by Leslie Fay and its competitors. The new trend of casual clothes had a major effect on sales of dresses in the clothing industry.

Another factor that played a role on slow sales was the recession which started in the late 1980's and lasted until the early 1990's. Consumers were spending less on clothes as they were not a necessity and a long lived asset. Many of Leslie Fay's customers, large department stores, filed for bankruptcy causing Leslie Fay to incur a substantial loss having to writing off uncollectable receivables. One of Leslie Fay's close competitors, Liz Claiborne, saw its revenues sky rocket to $1 billion in 1987, but saw hiccups in revenues and faced slowing sales from its major product lines due to write downs of inventory.

Despite the economic changes affecting the women's apparel industry, Leslie Fay reported impressive sales and earnings throughout the late 1980's and early 1990's. In the fall of 1991, John Pomerantz even stated to the public that Leslie Fay had achieved record earnings for the quarter, even though retail sales were sluggish and consumers were not spending.

Competitors were astonished at how Leslie Fay, with outdated manufacturing and untrendy clothes, could report positive earnings in an economic struggle such as the one faced in the late 1980's and early 1990s by the industry. But in fact, John Pomerantz had to keep his customers happy by approving markdowns in wholesale prices of his inventory and offering large rebates when retailers found themselves "stuck" with excessive inventory. To keep the public bullish about Leslie Fay's stock as well as keep Leslie Fay's stock's selling price from falling, John even reprimanded an analyst who issued a "pessimistic" earnings forecast.

Audit/Accounting Issues

Late January, 1993, is when the issues started to unravel Leslie Fay Corporation. It was then that Paul Polishan informed his boss John Pomerantz that Donald Kenia, the controller of Leslie Fay Corporation, secretively carried out a vast accounting fraud over several years. When the fraud was released to the press, all the executives denied being informed of the fraud and or knowing what would have motivated Donald Kenia to misrepresent Leslie Fay's financial statements. John Pomerantz, when responding to critics, claimed to be a victim of the fraud perpetrated by his accounting staff.

After Pomerantz informed the public regarding the fraud, Leslie Fay's audit committee launched an extensive investigation and retained Arthur Anderson & Co. to help complete the report. During the investigation, pending an outcome, Pomerantz placed Polishan on temporary paid leave. BDO Seidman had served as the auditor since late 1970's and repeatedly issued unqualified reports for Leslie Fay. BDO clearly missed key factors of the fraud such as the existence and valuation of inventory by Leslie Fay. BDO did not follow the audit standards by being observant and inspecting inventory claims on the financial statements by tracing, vouching, or scanning inventory assertions made by management.

According to the investigation completed by the audit-committee and Arthur Anderson & Co. it was evident that Kenia and his subordinates inflated the inventory numbers. The numbers of dresses manufactured each quarterly period were inflated to reduce the per-unit cost of finished goods and inventory they had entered into the previous accounting records. Common ways of overstating inventory used by the Leslie Fay fraudsters were to forge inventory tags for nonexistent products during period-ending physical inventory counts, inflating the number of dress on hand, and fabricating large amounts of false in-transit inventory.

The investigation also uncovered other GAAP departures presumably conducted by Donald Kenia that were not detected by BDO in their audits. GAAP departures discovered in the investigation included: failing to accrue period-ending expenses and liabilities, falsely recording orders before being received from customers to boost sales, failing to write off uncollectible receivables, and ignoring discounts on outstanding receivables granted to customers who experienced troubles with sales of Leslie Fay's products. It was also uncovered that Kenia was misrepresenting profits each quarter, he would tell his subordinates an amount he deemed accurate to report as profits and made his subordinates achieve them by adjusting the numbers on the financial statements. Donald Kenia and the accounting staff at Leslie Fay also fabricated the numbers to depict financial ratios that would be consistent with historical trends. BDO Seidman relied on historical trends and did not conduct analytical procedures such as comparing financial ratios of Leslie Fay to close competitors, allowing the Fraud to go undetected. From 1990 through the end of 1992, a total of $130 million of entries were fallaciously made in the accounting records overstating the profit by $80 million. While the fraud was being perpetrated large bonuses were also paid out to executives based on earnings.

Aftermath

Leslie Fay filed for bankruptcy in April 1993, because press reports of the fraud cut off access to debt and capital the company needed to operate on a daily basis. The stock price of Leslie Fay plummeted by 85% triggering lawsuits by shareholders naming Leslie Fay executives and BDO Seidman as defendants. During court hearings many criticized the fact that John Pomerantz was not being held accountable in the Fraud as a perpetrator. Thus, the courts hired an independent auditor, Charles Stillman, to investigate Leslie Fay and release an independent report. The Stillman report also exonerated John Pomerantz of any wrong doing, but listed BDO Seidman as acting negligently in preparing the audits.

On October 31, 1996, federal prosecution filed a 21-count fraud charge against Paul Polishan after Donald Kenia broke down in questioning. Donald told the federal investigators that Polishan was the mastermind of the fraud, overseeing all of it and the only reason he and his subordinates took the blame was because of Paul's intimidating demeanour.

In 1997, after seven long years of investigations and court hearings, a federal judge approved $34 million in settlement to the class action lawsuit filed. BDO Seidman contributed $8 million in the payouts to the plaintiffs. Later, in 2001, Polishan was convicted for 18 of 21 counts of fraud and sentenced to serve nine years in federal prison. For Donald Kenia's testimony, he was allowed to plead guilty to two counts of making false statements to the SEC and was sentenced to two years in a correctional facility known for white collar crimes, located in Pennsylvania.

Audit Case Questions

Question 1 *(Please See Appendix 1 through 3 for Ratios and Common Sized Statements)*

1) Despite a downturn in the women's apparel industry, Leslie Fay's sales steadily increased on a year-to-year basis, except for in 1991.
2) Inventory is another account that is of special interest. Most people in the industry felt that Leslie Fay was not very up to date with the latest fashion. As a result of this, one would expect them to have significant write-offs for items not selling in department stores, yet, inventory levels remained constant.
3) Other accounts BDO Seidman could have looked into were Accounts Receivable and Accounts Payable.

Question 2

In addition to the Balance Sheets and Income Statements for the period 1987 to 1991, as well as the industry ratios, BDO Seidman should have requested the following information:

- Information concerning Accounts Receivable: This can be obtained by contacting the department stores Leslie Fay supplied, to get confirmation of all sales and returns of inventory.
- Proof of payment of all these accounts
- Information concerning Accounts Payable: Contact all Leslie Fay's suppliers to obtain confirmation of inventory supplied.
- Proof of Payment on all these accounts

By obtaining this information, BDO Seidman would have been in a better position to verify sales and inventory levels.

Question 3

The following are non-financial factors regarding a client's industry that auditors should consider when planning an audit:

The type of industry – Certain industries are naturally risky, for example, those that must use complex accounting estimates. An auditor must consider the type of industry the client is in order to assess inherent risk. If the chance of material misstatement is high, simply due to the nature of the company, the auditor must assess inherent risk as high. A high inherent risk will require more work to be done by the auditor in order to reduce detection risk and thereby audit risk.

Current industry issues – There may be many external issues impacting an entire industry, like changing fashions in the case of the garment industry. These may have positive or negative financial effects on companies within said industry. An auditor must be aware of these issues and consider the impact they would have on a client's financial statements. They must then ensure that the financial statements reflect that expectation and if not, the auditor should find out why there is a difference.

Impact of current economic environment on industry – Similar to the previous point, changes in the economy can impact entire industries. In this case, a recession caused companies across the industry to experience slowed sales and to take large inventory write-downs. Leslie Fay on the other hand was apparently experiencing record earnings. An auditor should pay attention to how the economy is affecting the industry as a whole and compare this to how their client is performing financially. Once again, if they do not match up, the auditor should inquire as to why there is a mismatch.

Question 4

Paul Polishan ran the accounting offices of Leslie Fay Company like a dictator, to the point of them being nicknamed "Poliworld." He used intimidation to control his subordinates on a regular basis. Dominating the other employees in this way gave Polishan the ability to override internal controls. Not only would no one question him if he did anything wrong, but he was actually able to force others to do the dirty work for him. Circumstances such as this imply more work for a company's independent auditors. While assessing the risk of a business in order to plan the audit, the auditors would include circumstances like this in their calculations. Since Polishan can essentially override any and all internal controls, the independent auditors would have to assess control risk as high. A high control risk means that auditors will have to do more work, such as collecting more evidence, so that they can reduce the detection risk. This is the risk that a material misstatement will not be detected by the auditor. The detection risk must be reduced in order to lower audit risk to the level the auditors consider acceptable. The audit risk is the risk the auditor is willing to take that the audit will fail.

The formula for calculating audit risk is: Audit Risk = Inherent Risk × Control Risk × Detection Risk

Question 5

The SEC ruled that BDO Seidman's independence was jeopardized by the lawsuit that named them and top executives of Leslie Fay as co-defendants. Under the standards of AICPA and the independence principle, an auditors independence is considered to be impaired if they are facing litigation by security holders. According to AICPA rule 101, litigation between an auditor and security holders does not in itself alter fundamental relationships between the client and its management and therefore would not be deemed to have an adverse impact on independence. However, APICA also states that situations should also be examined carefully, since the potential for adverse interests may exist if cross-claims are filed against the auditors alleging that the auditor is responsible for any deficiencies, fraud or deceit by the present management because of negligent audit work. (Source: www.aicpa.org & textbook page 108)

Appendix I

Liquidity:						
Current Ratio	1.8	2.91	2.64	2.75	2.2	2.58
Quick Ratio	0.9	1.33	1.21	1.28	1.06	1.21
Solvency:						
Debt to Assets	0.53	0.45	0.57	0.59	0.63	0.63
Times Interest Earned	4.2	2.41	2.61	2.27	2.12	1.6
Long-term Debt to Equity	0.14	0.39	0.69	0.81	0.32	0.38
Activity:						
Inventory Turnover	6.7	6.59	5.81	6.49	6.38	7.01
Age of Inventory	53.7	55.39	62.82	56.24	57.21	52.07
Accounts Receivable **Turnover:**	8	6.47	6.69	6.92	7.08	–
Age of Accounts Receivable	45.5	56.41	54.56	52.75	51.55	–
Total Asset Turnover	3.1	2.11	1.96	2.03	1.88	1.91
Profitability:						
Gross Margin	31.50%	30.10%	31.45	31.70%	31.70%	30.70%
Profit Margin on Sales	2.20%	3.43%	3.39%	3.29%	3.27%	3.39%
Return on Total Assets	6.00%	15.80%	15.38%	16.29%	15.67%	13.95%
Return on Equity	14.00%	13.62%	15.51%	16.16%	16.67%	17.61%

Appendix II

The Leslie Fay Companies Consolidated Income Statements 1987 - 1991 (common sized)	1991	1990	1989	1988	1987
Net Sales	100%	100%	100%	100%	100%
Cost of Sales	69.90%	68.60%	68.30%	68.30%	69.30%
Gross Profit	30.10%	31.40%	31.70%	31.70%	30.70%
Operating Expenses					
Selling, Warehouse, and					
General Administrative	22.27%	23.17%	23.38%	22.88%	22.77%
Amortization of Intangibles	0.32%	0.34%	0.33%	0.48%	0.65%
Total Operating Expenses	22.59%	23.54%	23.71%	23.36%	23.42%
Operating Income	7.47%	7.86%	8.02%	8.33%	7.32%
Interest Expense	2.19%	2.18%	2.45%	2.67%	2.82%
Income before non-recurring Charges	5.29%	5.68%	5.57%	5.67%	4.50%
Non-recurring Charges (Credits)	–	–	–	–	-0.86%
Income Before Taxes on Income	5.29%	5.68%	5.57%	5.67%	5.36%
Income Taxes	1.77%	2.29%	2.29%	2.40%	1.98%
Net Income	3.43%	3.39%	3.29%	3.27%	3.39%
Net Income per Share					

Appendix III

The Leslie Fay Companies
Consolidated Balance Sheets 1987-1991
(common sized)

ASSETS	1991	1990	1989	1988	1987
Current Assets:					
Cash	1.19%	1.07%	1.42%	1.52%	1.34%
Receivables (net)	30.04%	31.78%	30.29%	30.28%	27.14%
Inventories	32.04%	33.70%	31.27%	29.48%	27.18%
Prepaid Expenses & Other Current Assets	4.98%	5.13%	5.03%	4.52%	5.21%
Total Current Assets	68.24%	71.68%	68.01%	65.79%	60.87%
Property, Plant, and Equipment	9.90%	6.84%	7.02%	7.13%	7.89%
Goodwill	20.54%	20.07%	23.55%	25.92%	29.57%
Deferred Charges and Other Assets	1.31%	1.41%	1.42%	1.16%	1.67%
Total Assets	100.00%	100.00%	100.00%	100.00%	100.00%
LIABILITIES AND SHAREHOLDERS EQUITY					
Current Liabilities:					
Notes Payable	8.84%	10.94%	5.94%	7.99%	5.08%
Current Maturities of Long-term Debt	0.08%	0.07%	0.08%	0.08%	0.50%
Accounts Payable	8.06%	9.87%	9.97%	12.57%	10.35%
Accrued Interest Payable	0.76%	0.87%	1.06%	1.07%	1.21%
Accrued Compensation	4.27%	3.39%	5.03%	4.58%	3.47%
Accrued Expenses & Other	1.09%	1.46%	1.50%	1.98%	2.42%
Income Taxes Payable	0.35%	0.52%	1.19%	1.68%	0.59%
Total Current Liabilities	23.45%	27.11%	24.76%	28.94%	23.58%
Long-term Debt	21.32%	29.55%	33.30%	35.54%	38.18%
Deferred Credits & Other Noncurrent Liabilities	0.71%	0.59%	0.70%	0.74%	1.60%
Shareholders’ Equity:					
Common Stock	5.05%	4.56%	5.16%	5.51%	6.55%
Capital in Excess of Par Value	20.77%	18.73%	21.20%	22.64%	26.92%
Retained Earnings	39.64%	29.07%	25.43%	20.06%	16.54%
Other	-8.67%	-7.10%	-8.24%	-8.80%	-10.38%
Treasury Stock	-2.23%	-2.44%	-2.35%	-2.51%	-2.98%
Total Shareholders’ Equity	54.52%	42.74%	41.23%	36.86%	36.64%
Total Liabilities and Shareholders’ Equity	100.00%	100.00%	100.00%	100.00%	100.00%