The Leslie Fay Companies

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Outline / Road Map

1) Case Facts/Background
2) Computing and Comparing Financial Statements (Q1)
3) Recommendations to BDO
4) Non-financial variables Auditors should consider
5) How to Overcome Paul Polishan, recommendations for Audit team
6) Explaining SEC's ruling
7) Something extra
8) What surprised us
9) Conclusion

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Case Facts & Background: The Story of Leslie Fay

Leslie Fay Companies: Women's Apparel Line

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Early Years

WWII — Role in the War

Fred Pomerantz manufactured uniforms for the Women's Army Corps.

Post WWII — Company Founded

Fred put his skills to use and founded a company named after his daughter, Leslie Fay

1952 — Publicly Traded

Pomerantz took the company public

Early 1980's — Leveraged Buyout

Leslie Fay went private for a few years through a leveraged buyout

1982 — New CEO

Fred's son, John Pomerantz, became new CEO and chairman of the board after Fred's death

1986 — Back for Round 2

Leslie Fay becomes public for the second time, allowing John to pocket $40M due to the transition

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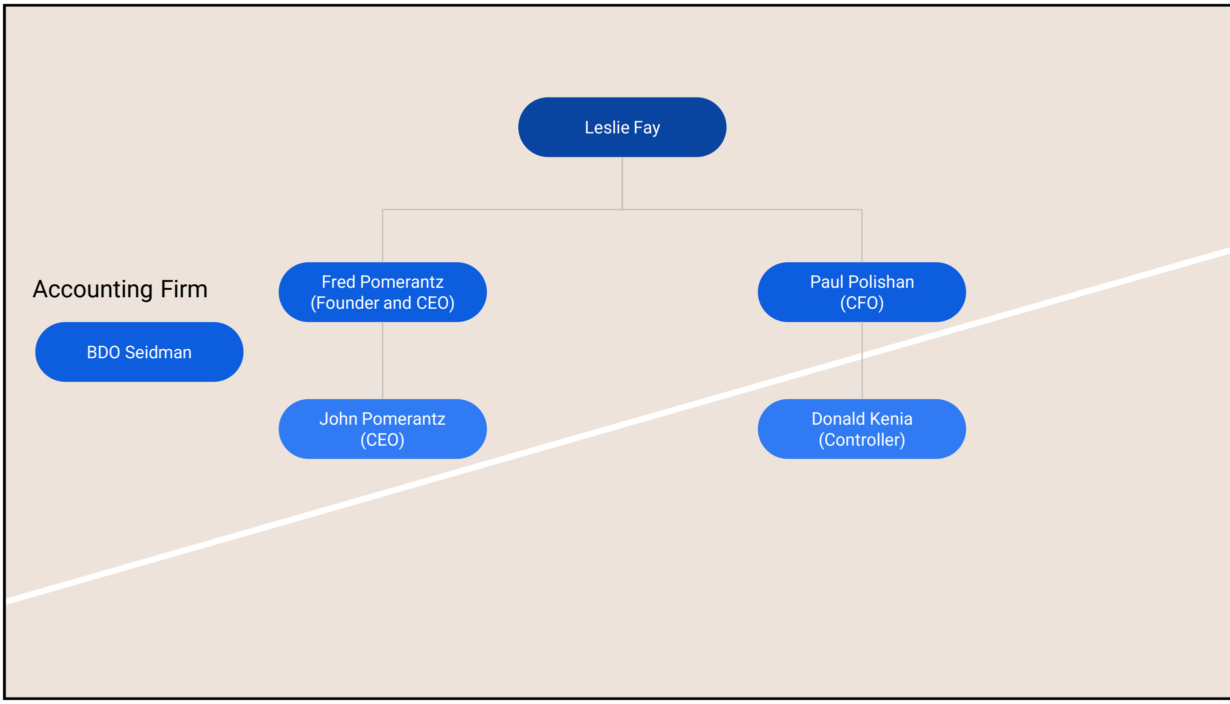

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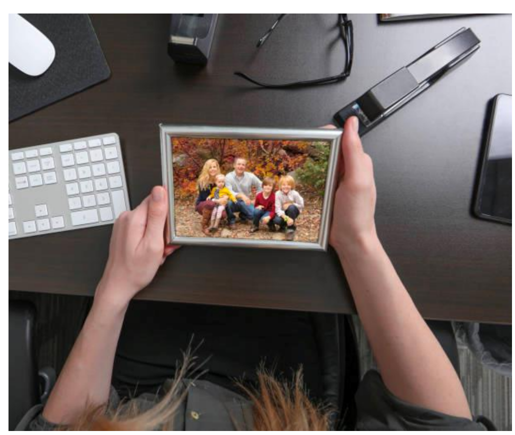
Paul Polishan: CFO

- Hired in 1969 by Fred
- Quickly rose to CFO
- Described as ambitious and driven by Fred
- Polishan become John Pomerantz most trusted ally within the company
- PoliWorld
  - Accounting offices of Leslie Fay
  - 16 hour shifts and overtime on weekends
  - One family picture on desk
  - Demands why when financial documents are needed in the corporate office



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Lay out of business

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Continued Success and Lavish Lifestyle

- In the early years, Fred was described as a “character” hosting lavish parties, excessively gambling, and driving a bright red Rolls Royce around the streets of Manhattan.
- Pomerantz was successful because he targeted a key segment of the fashion market: Women ages 30 to 55 who wanted dresses that were moderately priced and slightly conservative
- By the late 1980’s, Leslie Fay was the largest supplier of women’s dresses to department stores
- Like his father, John Pomerantz shared his lavish tendencies. He was a regular in Manhattan’s celebrity circuit and owned a elegant estate in Palm Beach, Florida alongside New York’s rich and famous.

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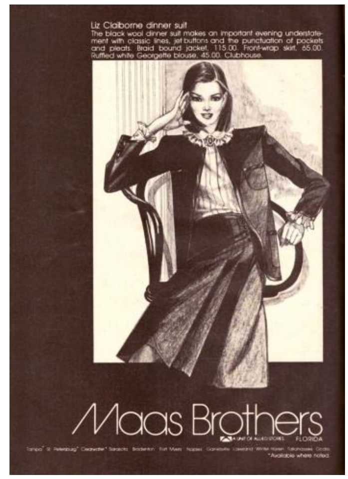
Increased Competition and Pressure to Perform

- After years of dominating the women's dress industry, Leslie Fay had many competitors arise.
- Liz Claiborne, an upstart company, soon became a household name and became on their closet and fiercest rivals.
- Trends in the late 1980's were rapidly changing. Americans had less money to spend on new designs and opted for more casual clothing, including denim and t-shirts.
- Dress sales were dramatically impacted and Pomerantz felt massive pressure to continue his father's legacy.



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"Fashion Becomes Unfashionable"

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Leslie Fay's Lack of Innovation

John Pomerantz continues to run the business like this father did:

- Did not engage in market testing
- Reluctance to integrate computers
- Telephoning large customers
- Did not innovate compared to competition

"Overpriced" **"Drab"**

"Old-Fashioned"

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October 1991

John Pomerantz announced that Leslie Fay had achieved record earnings in the third quarter despite the "continued sluggishness in retail sales and consumer spending"

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“Houston we have a problem”

- On January 29th, 1993 Polishan calls to tell Pomerantz about Kenia’s accounting hoax
- Pomerantz (CEO) denies of Corporate Office knowing anything about the scandal
- Pomerantz defends Polishan and said “he knew nothing about this”
    - Pomerantz: “In my heart, I feel that I’m a victim”
- BDO Seidman, Leslie Fay’s audit firm since the mid-1970’s, issued unqualified opinions for the years preceding the fraud.
- BDO Seidman withdrew their 1990 and 1991 audit opinions

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Donald Kenia

- Polishan’s quiet lieutenant
- Accepted responsibility for $80 million fraud
- No incentive - based compensation package
- Polishan and Pomerantz claimed to have no knowledge of the fraud although it directly impacted their pay
- Many felt it didn’t add up
- Friends of Kenia said he wouldn’t be capable of doing this alone

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The Fraud: How it was done

Kenia and subordinates inflated the number of dresses each quarter to reduce cost per unit and boost Gross Profit Margin of Sales

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During year-end inventory, Kenia and conspirators would “manufacture” phantom inventory they previously recorded to overstate inventory

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Also forged inventory tags for non-existent products, inflating counts of inventory on hand, and fabricating large amounts of inventory “in-transit”

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How it was done Part 2

Kenia also failed to accrue period ending expenses and liabilities, pre-recording orders received from customers as consummated sales to boost revenues.

Kenia used his position as the Controller to decide what Profits should be reported each period

Between 1990-1992 the accounting fraud overstated Fay’s profits by **$80 Million**

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Reaction to the Fraud

Leslie Fay’s stock price drops 85% within 2 months of the fraud becoming public

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Aftermath: BDO Seidman

BDO resigned as Leslie Fay’s auditor:

- Encouraged by the SEC
- Lawsuits were launched by investors and creditors
- BDO, Leslie Fay, Leslie Fay Executives named codefendants
- Independence deemed to have been jeopardized

Upon conclusion of the investigation, a 600 page report was submitted to the SEC

BDO still insisted they were the victim and didn’t act negligent when auditing

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Fraud Outcomes

- Leslie Fay filed Chapter 11 Bankruptcy in April 1993

- July 1997- $34 million settlement to stockholders and creditors
- BDO contributes $8 million to the settlement pool
    - Finally agreed to settlement because it was the most economical and expeditious way to “put this matter behind us”

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Impact of the Stillman Report on Lawsuits

In August 1994, the U.S. Bankruptcy Court released the “Stillman Report”:
- Corroborated the key findings of the 600 page audit investigation
- Exonerated Leslie Fay’s current management and its board (including Pomerantz)
- Suggested there were “viable claims” against Polishan and Kenia
- Found claims worth pursuing against BDO seidman
    - They likely acted negligent

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Punishments and Outcomes of the Lawsuits

Kenia
- Originally admitted full responsibility and was interrogated about the fraud
- Admits that Polishan had been the architect of the fraud
- Polishan intimidating personality persuaded Kenia and his other subordinates to make enormous numbers of fraudulent entries
- He was sentenced to 2 years in prison

Polishan
- He was convicted on 18 of 21 counts of fraud and was sentenced to 9 years in prison
- Polishan tried to appeal the verdict
- The judge denied the appeal while noting that he had “dominated” Kenia through intimidation and fear

Pomerantz
- In June 1997, Leslie Fay emerged from federal bankruptcy court and continued the much smaller company to a profitable condition
- In late 2001, the company was bought out by a large investment fund
- April 2002: he received a lifetime achievement award at the American Image Awards

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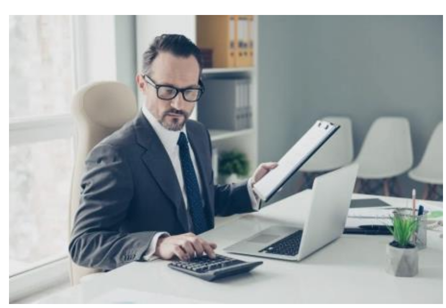
Computing and Comparing Financial Statements

Financial statements: https://docs.google.com/spreadsheets/d/1SpY2zspc2j_14u0qgY-HrEQr2qNKTT3zO3T2TYdg9K8/edit#gid=0



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Q1: Financial Statement items of High Risk

Net Sales

- Largest line item
- Showed steady growth throughout the years, despite the industry going through a recession (1991 was the only year that show a slight drop)

Inventories

- Highest valued asset
- Recession caused retail industry to slow down
- Age of inventory was much higher than industry average while inventory turnover was much lower than the average

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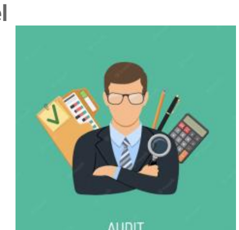
Q2:Other information that should've been obtained

- **Accounts Receivable aging**
  - **Shows if company clients are paying on time and if there are any adjustments that need to be made**
- **Order Backlog**
  - **Shows what orders have been booked but not delivered**
- **Detailed sales information broken down by customer, product line, and sales channel**
  - **Could disclose potential problems with certain product lines or client accounts**



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Q3:Non Financial Variables that BDO should have considered during their audit

- Type of business and risks associated with that business
  - Fashion is trend-based business and if the company doesn't stay up to date, it could fall behind
  - Because Leslie Fay was a merchandising company, inventory should be accurately checked
- Competitiveness within the business
  - Many other women's clothing brands were competing for department store space
  - This high level of competition pushed their margins down and could increase the risk of improper reporting
- High obsolescence, trendiness and other inventory risks
  - Companies that earn their revenues from consumer spending may have financials that are susceptible to changes in consumer spending
  - Rapid changes in consumer tastes may result in the need to write off large amounts of inventory
  - The economy was down and had an industry wide effect, yet Leslie Fay seemed immune

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Q4: Paul Polishan's Dictatorship over the Accounting Department

Implications for a company's independent auditors

- Scope limitations on what the auditor has access to
- Uncooperative management when trying to acquire financial information
- Pressure imposed to issue a clean opinion

How auditors should take such circumstances into consideration when planning the audit

- Because of Polishan's dominance in the company's financial reporting, there may be a lack of checks and balances
- This creates an opportunity for potential fraud and auditors should be prepared to consider this risk in their audit
- With fewer people involved in certain levels of accounting and reporting, it's easier to perpetrate irregularities

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Q5: How was BDO Seidman's Independence jeopardized?

Due to BDO Seidman, Leslie Fay, and top executives at Leslie Fay being listed as co defendants, BDO Seidman's independence was jeopardized.

Why?

- During the course of the lawsuit, BDO Seidman would likely try to shift the blame to Leslie Fay and vice versa
- This creates a hostile relationship between the accounting firm and client, Leslie Fay
- Because of this hostile relationship, the SEC had to put an end to the auditor-client relationship between BDO Seidman and Leslie Fay

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What surprised us

- The lack of communication between Corporate HeadQuarters and the Accounting Office
- Lack of insight from BDO when retail industry was suffering as a whole
- How the CEO was not involved in the fraud

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Something extra

https://hbr.org/2010/04/what-john-pomerantz-former-ceo

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Conclusions and Key Takeaways

- Auditors should be aware of industry trends as well how a client can either exceed or not reach industry expectations
- Should be a level of oversight between different departments Ex:between corporate HQ and Accounting Department
- Inventory management can be a key item for fraud in retail companies

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Questions?

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Sources

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