

How to detect account manipulation. The Real Gowex Case

NICOLA EUSEBIO
University of Milano-Bicocca.

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ABSTRACT

The subject of the following article regards the investigation methods about the consistency and reliability of the financial information. In order to show how to detect the account manipulation, we will apply some financial and nonfinancial methods suggested by researchers of this field, to a real case of account manipulator, a Spanish company "Let's Gowex". Through horizontal and vertical analysis and cash flow, we will try to find the inconsistency and anomalies between the financial data, very important signal of account manipulation. The "fraud triangle" analysis, suggested by SAS 99, will be also presented. We will discuss the importance of the Corporate Governance in the fraud prevention. Using our final findings, which show several warning signals (red flags), we will conclude that account manipulation in Gowex could be detected if only the institutions were interested in, and responded appropriately.

Classification JEL: D21; K40; M42

KEYWORDS

Fraud detection, account manipulation, Gowex.

1. Introducción

Despite the financial disaster of Enron, WorldCom, Parmalat, and despite the more restrictive laws enacted in various countries to prevent the fraudulent financial activity, the cases of financial reporting fraud, have been constantly increasing.

For this reason, the fraudulent reporting detection, assumes the primary importance for institutions, auditors and investors.

The type of the fraud here analyzed regards **fraudulent financial reporting** defined by Association of Certified Fraud Examiner as “*The intentional, deliberate, misstatement or omission of material facts, or accounting data to mislead and, when considered with all the information made available, would cause the reader to alter his or her judgment in making a decision, usually with regards to investments.*” (ACFE 2014).

The accounting fraud can take various form therefore, the measures are wide.

Some of financial measures adopted by researchers are more suitable for a specific account manipulation. For example, Sloan Model, Dechow-Dichev Quality accruals Model, are proper for an accruals manipulation detection.

Other technics have a larger usefulness. The ratio analysis, horizontal and vertical analysis, M-Score Model of Beneish, Z-Score of Vladu-Amat-Cuzdrorien, Piotroski model, Lev-Thiagarajan 12 Signals, Benford Law and all nonfinancial methods, are effective to discover an account manipulation in several forms and cases.

Due to the space limitation, we will show here most but not all, methods of account manipulation detection. Precisely: first, the **fraud risk triangle**¹ concerning Gowex will be created.

Afterwards, we will evaluate the financial health of Gowex. Applying the Bankruptcy Model of Altman, we will see if one of important fraud risk factors, a pressure, due to financial trouble of company, was existing in Gowex.

The next step will consist in analyzing the basic financial information of Gowex: Balance Sheet, Profit and Loss Statement and Cash Flow of the last years. Their deep analysis will permit us to find the inconsistency between the various items which should be consider as red flags and request further investigation.

Then, we will apply the most popular and effective measures to detect the account manipulation.

1. Fraud Triangle Theory. Donald R. Cressey, 1973.

We will start that using at first, the linear discriminant analysis method specifically created to detect the financial statement manipulation: M-Score Beneish Model and Z-Score Model of Vladu – Amat – Cuzdrorien. We expect the overall scores of models confirming the account manipulations in Gowex.

We will continue our analysis considering nonfinancial measures, which due to their characteristic can be effectively analyzed only by benchmarking with competitors.

As you will see, the nonfinancial methods should be considered as an essential tool, in the efficient account manipulation detection.

2. An amazing story of a Spanish, telecommunication company: Let's Gowex ("Gowex")

Jenaro García Martín founded Let's Gowex SA in 1999. Known as Iber-X until 2008, it started as a telecommunications broker that provided a place for companies to buy and sell voice minutes and bandwidth capacity. From 2004 on, Gowex focused on the installation of WI-FI in public spaces like streets, train station or airports. The company's goal was to create "Wi-Fi cities" all over the world (Reuters, 2014).

For the expansion of the company, Garcia Martin needed capital. On 12 March 2010, he took the company public. Its market value jumped by almost 40 times, peaking at €1.9 billion on April 3. Gowex reported a sevenfold increase in revenue over three years, reaching €183 million in 2013.

Gowex became the first and only Spanish to list its shares on two exchanges with quotations on both the MAB stock market (GOW) and on the NYSE-Alternext (ALGOW).

In 2013 Gowex reported in its financial statement the revenue of 182,6 Mio € (+416% comparing to 2009) and the net profit of 28,9 mio € (+906% comparing 2009).

For these reasons, Gowex had been repeatedly hailed as a rare Spanish high-tech success story. Impressed by claims of rapid growth in sales and profits, investors drove up the company's share price more than 30-fold between Gowex's initial offering in 2010 and the all-time high last year (Bloomberg, 2014).

Not only investors were deceived. In 2013, the Federation of European Stock Exchanges picked Gowex as "best new listed company." Prime Minister Mariano Rajoy honored García for creating a company that "thought globally." Moreover, in May, Gowex won the top award from the Spanish Marketing Association—though the group says it has taken it back (Bloomberg, 2014).

No one from big financial analysts had cast doubts about so spectacular Gowex performance, a part one, a small, independent US analysis firm called “Gotham City Research LLC”.

3. A devastating report about the company released by “Gotham City Research”

1 July 2014 Gotham City released a 93-page report calling for Let’s Gowex SA shares stock to go to zero, alleging that more than 90% of its revenues were “suspect”.

Gotham City’s report, published after eight months of diligence on Let’s Gowex, indicated the following, shocking findings (Gotham City 2014):

- Gowex’s actual Wireless revenues are at most 10% of what GOW reports in its financial statements.
- GOW’s Hotspot network it owns or manages is ~5K in size while Govex CEO reports = 100K.
- GOW’s audit fee is €40,000, which makes sense if Gowex’s actual revenues are only 5%-10% of reported revenue.
- 90% of Telecom revenue originated from undisclosed related parties, tied to GOW CFO & an early investor. It is an evidence Gowex’s largest customer was really itself.
- Gowex told some investors that New York City was paying them €7.5 million.

The real number is <€200,000, according to New York City.

- Gowex does not publicly disclose basic metrics, such as hotspot count or details of wireless revenue segment.
- The June 5th Mall Plaza press release (in English) makes demonstrably false claims. The same press release in the native Spanish omits the false claims.
- GOWEX lied to the European Union’s Transparency Register, claiming it spent over €50 mm in political contributions.

Following Gotham’s initial report, Let’s Gowex said the report “*has major factual inaccuracies and false statements which the Company considers defamatory.*” (elpais.com 2014).

On July 6, the company declared itself insolvent. The company’s CEO, Garcia Martin, also resigned after telling the company’s board that its financials over at least the last four years were falsified.

4. The true story of Let's Gowex Company

Interviews with the CEO Garcia Martin, with Gowex employees and regulators, as well as court documents, show how some of the dodges behind his deception were surprisingly basic. The following “true story” of Gowex is taken from the article published on line by Reuters (08/2014).

Garcia Martinez began to misrepresent the real state of the firm's accounts when a lawsuit knocked the company into a “downward spiral”. Neo Sky, a telecoms company, had sued the-then Iber-X for payment of 142,334.33 euros in telecommunications circuits rent in 2004. Garcia Martin's firm – now called Gowex – was ordered to pay compensation. However, Gowex was not able to pay it. And the lies have started.

Garcia Martin registered several firms and presented them, as clients in Gowex's books. Among them were two companies administered by Gowex's chief financial officer Fernando Martinez Marugan. The shell companies acted as fake customers on contracts that Gowex could show to lenders, investors, and government officials who signed off on subsidies.

“Basically, we started with three companies and what we do is: One company bills to Gowex, Gowex bills to another company and the third company bills to the previous one. It is a triangle,” Garcia Martin told the court.

At his court hearing, former CFO Marugan said only about 10 percent of the company's revenues were real. The lies continued after the listing. Garcia Martin and Marugan routinely misrepresented the size – and in one case even the existence – of business deals. For example, Gowex said in 2011 it had signed a 12million euro contract to provide WI-FI in public places in Buenos Aires, including the city's underground network. While Gowex and Buenos Aires authorities did have talks over a potential deal, the transaction was never agreed and both the municipality and the Subte metro company told Reuters they never signed any deal and had no knowledge of Gowex's announcement.

The firm said in 2013 that it had installed 1,953 free WI-FI hotspots in New York City in what it called a landmark deal in its expansion. However, the New York City Economic Development Corporation said the agreement to provide coverage in areas of the city such as Flatiron and Roosevelt Island was worth just \$245,000, a fraction of Gowex's overall reported revenue that year.

Such contracts enabled Gowex to seek bank loans and qualify for official subsidies. It used that cash to pay salaries, running costs, and taxes. Gowex paid 10.6 million euros in taxes in 2013, or 27 percent of its reported profits. “Jenaro would always be up to date with taxes,” said a person who worked with Garcia Martin for several years.

In spite of this, the Spanish Tax Office opened an investigation into failed Gowex in February 2013, to check on company tax and VAT paid during the years 2008 to 2010. The investigators found a number of irregularities and spent more than a year examining the company's books.

The Tax Office also reported, "In 2010, massive amounts of funds surfaced in Costa Rica. In total, the amount deposited in those accounts during that tax year, attributed by Let's Gowex to client charges, totaled €12,104,796, while withdrawals were as high as €4,295,288." This, the report continued, suggested the "possible existence of income that had been hidden from the Tax Office." (El Pais 2014).

The Tax Office also detected "presumed falsification of part of its activity (fake invoices, shell companies, non-existent clients) so that the company's activity would appear greater than it was in reality".

5. Was it possible to detect the fraudulent financial statement of Gowex?

After describing this incredible story, the question arises spontaneously.

Was it possible to detect the account manipulation by Gowex managers in time, using the appropriate methods proposed by various researchers of this field?

We will try here to give the answer at that important question.

5.1. The fraud risk factors ("Fraud Triangle")

Actually all international audit standards require the auditor to consider the risk of fraud when conducting audit engagement. An investor can do the same.

Three conditions typically are present when individuals commit fraud: **pressure** or an incentive to engage in fraud, a perceived **opportunity**, and the **ability to rationalize** fraudulent behavior. Noted twentieth century criminologist Donald Cressey first developed this "fraud triangle".

(Cressey, 1973). If all three of these factors are present, there is a high likelihood that a fraud will be committed. (Loebbecke, Eining, and Willingham, 1989). These three factors are considered by SAS n. 99 as "**fraud risk factors**".

How can we describe the fraud risks in Gowex? Below we propose the following fraud triangle interpretation knowing its limitation due to lack of more details available on this fraud case.

The pressure due to the financial trouble of the company gives an important risk factor. It is an aspect that should be always verified because it represents most important incentive to manipulate the financial data in order to obtain financing at favorable terms or encouraging investment through the sale of stock.

5.2. Bankruptcy model of Altman in case of GOWEX

The bankruptcy model of Altman may be used to predict the probability that a firm will go into bankruptcy within two years. Investors can use Altman Z-scores to help determine whether they should buy or sell a particular stock if they are concerned about the underlying company’s financial strength.

The Altman Z-score, is based on five financial ratios that can be calculated from data found on a company’s annual report. We will use here his revised Z-score model (Altman 2000) estimated for private firms (figure 1):

$$Z' = 0.717(X_1) + 0.847(X_2) + 3.107(X_3) + 0.420(X_4) + 0.998(X_5)$$

Weights	Variables	2013	2012	2011	2010	2009
0,717	X ₁ = Working Capit. /Tot. Assets	0,265	0,454	0,352	0,281	0,250
0,847	X ₂ = Retained Earnings /Total Asse	-0,003	-0,001	-0,0001	-0,0005	0,0000
3,107	X ₃ = EBIT / Total Assets	0,752	0,685	0,523	0,396	0,359
0,420	X ₄ =Book value of Equity /Tot. Liab	0,093	0,151	0,136	0,099	0,078
0,998	X ₅ = Sales/ Total Assets	1,119	1,132	1,162	1,001	1,159
Total Altman Z- Score calculation		2,227	2,421	2,172	1,776	1,846
"Safe Zone" : Z' > 2,99 ;		"Grey zone" : 1,23 > Z' < 2,99;		"Distress zone" : Z' < 1,23		

Figure 1. Altman Revised Model calculated for Gowex.

The calculation of the Altman model puts a company in the range of “**Grey zone**” for each year. The model does not indicate the distress zone, so theoretically should not be assign a “fraud pressure”. At the same, we have to point out that the company with so spectacular growth and so spectacular profit increase is not confirmed by Altman model as very attractive company to invest. In fact, in each year Gowex is far away from to reach the “safe zone” (Z' > 2,99).

Due to all these “Grey Zones” assigned to Gowex by Altman model, it is rather difficult to understand the reason of so high success of Gowex in the capital market until the scandal was been exploded.

6. Financial measures of probability of manipulations

The probability of account manipulation can be verified by two kind of measures: financial and nonfinancial.

Here, below we will see the application in the case of Gowex, the following financial methods:

1. Analysis of the inconsistencies in the financial information
2. Relationship between Net Profit and Cash from operation
3. M-score Model of Beneish
4. Vladu – Amat – Cuzdrorien linear model

6.1. Preliminary analysis of possible inconsistencies in the financial statements of Gowex

In order to find anomalies in the financial information of Gowex we will use the horizontal and vertical analyze of Balance Sheet and Profit and Loss Statement concerning the period: 2009 – 2013.

Just after having a first glance at the financial statement of Gowex, one will be impressed:

- **Turnover** increases strongly every year (see figure 2) (+73% in 2012, +60% in 2013) but the costs increase much less, so the Gross Profit increases more than Turnover (+87% in 2012, +70% in 2013). Also the fixed costs increase much less than turnover which causes the higher Operating Profit (+130% in 2012 and +78% in 2013).
- The financial incomes increase every year (in 2010:+ 499%) much more of the increase in financial costs (figure 2).
- Consequently the **Net Profit** shows every year a spectacular increase: +136% in 2012, +78% in 2013).

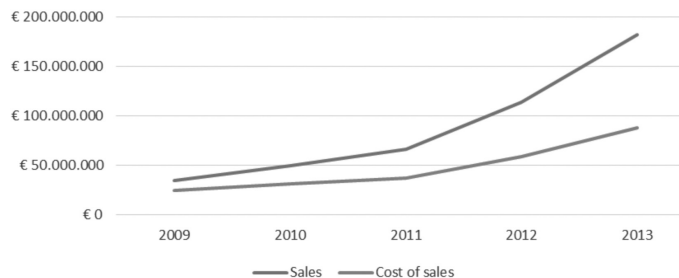


Figure 2. Sales and cost of sales in Gowex (2009-2013).

Observing the Balance Sheet, we can note that the trend is different comparing the correlated items in the P&L Statement.

- **Receivables change significantly** from year to year ranging from negative -68% to +254%. There is no consistency with sales increase. For example: in 2011 the sales increases +33% but receivables decreases -68%. In 2013 the sales increases + 60% but Trade receivable increases + 254%.

This inconsistency between sales and receivables is a **strong signal** of the sales manipulation, which should have been investigated more deeply by financial forensic examiner (Figure 3).

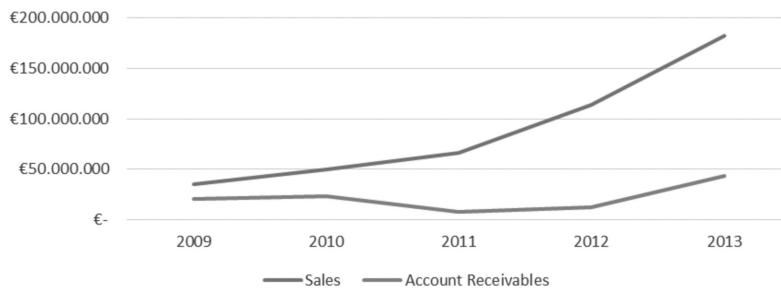


Figure 3. Sales and account receivables of Gowex (2009-2013).

The same inconsistencies exist between the trade payable and the costs. Without a logical explanations they should be considered an another red flag (Figure 4):

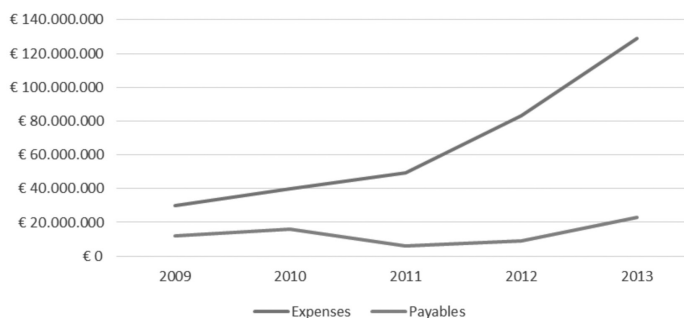


Figure 4. Expenses and Account Payables of Gowex (2009-2013).

6.2. Relationship between net profit and cash from operation (CRO analysis)

While it may be easier to manipulate financial statements to show profitability it is more difficult to manipulate cash flows.

For this reason, one of the most effective ways to analyze the probability of the account manipulation is to observe the “cash realization ratio” (CRO) where:

$$\text{CRO} = \text{Operating Cash Flow} \text{ divided } \text{Net Income} \text{ (Mantone 2013)}$$

See below this important measure to detect the account manipulation, applied to Gowex in period 2009 – 2013. In figure 5 we indicate the cash realization ratio (CRO) and figure 6 is a visual aid in form of a dual-axis chart:

	2009	2010	2011	2012	2013
Cash Flow from Operations (€)	5.174.482	6.777.119	17.925.702	19.839.864	28.806.826
Net Profit (€)	2.871.164	5.130.355	7.220.339	17.027.226	28.872.493
Cash Realization Ratio (CRO)	1,80	1,32	2,48	1,17	1,00

Figure 5. Cash Realization Ratio in GOWEX.

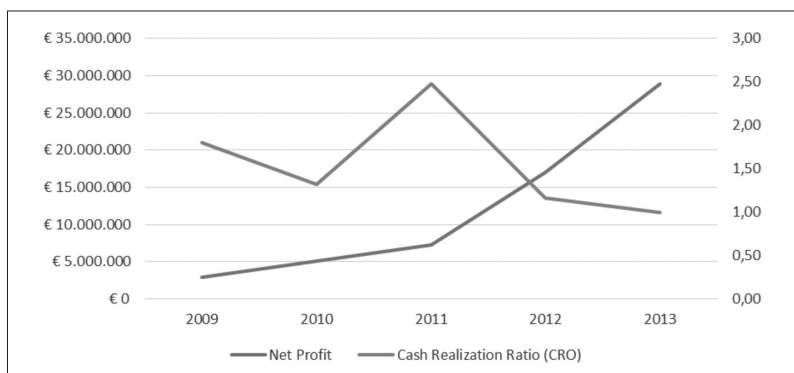


Figure 6. Cash realized from operation (CRO) versus Net Income in Gowex.

The calculation of CRO in Gowex shows in all the years, except 2013, outside the normal range of expectations:

- The chart illustrates that operating Cash Flows do not match net income since from 2009 to 2010 Net Profit is increasing while CRO is decreasing.
- From 2010 to 2012, Net Income increases at an accelerated rate compared to CRO.
- From 2012 to 2013, operating cash flows decrease while net income increases.

These abnormal anomalies confirm the financial statement manipulation at GOWEX since 2009.

5.3. The M-Score Model of Beneish

The model consists of eight individual ratios that are weighted and then combined into one index. (Beneish, 1999). The index is then used as a performance measure to evaluate the subject company for potential earnings manipulation.

The M-Score calculation appears as follows:

$$M = -4.84 + 0.92*DSRI + 0.528*GMI + 0.404*AQI + 0.892*SGI + 0.115*DEPI - 0.172*SGAI + 4.679*TATA - 0.327*LVGI$$

Beneish determined that if the calculation of the Model is **greater** than a negative **-2,22** the calculation suggests a **higher probability of financial statement manipulation**.

The analysis of real Gowex M-Scores results we can see in figure 7:

	2013	2012	2011	2010	Weights
DSRI (Days sales in receivable index)	1,81	0,93	0,28	0,89	0,920
GMI (Gross Margin Index)	0,94	0,92	0,84	0,82	0,528
AQI (Assets quality index)	1,36	0,73	0,91	0,77	0,404
SGI (Sales Growth index)	1,60	1,71	1,34	1,41	0,892
DI (Depreciation index)	1,45	0,72	1,04	1,77	0,115
SGAI (Selling, general and administ. expens)	0,97	0,96	1,12	1,18	0,172
TATA (Total accruals to total assets index)	0,00	-0,02	-0,18	-0,02	4,679
LI (Leverage index)	1,34	0,80	0,72	0,92	0,327
Costans	-4,840	-4,840	-4,840	-4,840	
The BENEISH M-SCORE	-1,1410	-2,1062	-3,6975	-2,4274	

Figure 7. Beneish M-Score for GOWEX.

The overall of M- scores indicate in **2013** and in **2012** there have been **the possibility of earnings manipulation** since all scores are higher than **-2,22**. Now, it would be useful to focus on each variable to develop further insight into the relationships from period to period (figure 8):

Variables	Manipulator Mean	Non manipulators Mean	2013	2012	2011	2010
DSRI	1,465	1,031	1,807	0,932	0,284	0,889
GMI	1,193	1,014	0,939	0,917	0,837	0,819
AQUI	1,254	1,039	1,363	0,730	0,914	0,766
SGI	1,607	1,134	1,597	1,714	1,344	1,411
DI	1,077	1,001	1,453	0,722	1,041	1,766
SGAI	1,041	1,054	0,972	0,957	1,122	1,176
TATA	0,0031	0,018	0,001	-0,019	-0,175	-0,023
LI	1,111	1,037	1,341	0,801	0,720	0,915

Figure 8. Red flags in Gowex Financial Statement for single M-Score variables.

We can see that several variables are out of “non manipulators range”, especially SGI, DI, SGAI which confirm the particular fraud of Gowex: the **fictitious revenues**.

6.4. The Vladu – Amat – Cuzdrorien Z-Score

This linear model is particularly important for the analysis of Gowex because it has been developed based on data from companies that are listed in the Spanish stock market (Vladu-Amat-Cuzdrorien, 2014).

The model considers four variables empirically verified to be linked in account manipulation:

- (1) **Receivables index: when it increases**
- (2) **Inventories index: when it increases**
- (3) **Depreciation index: when it decreases**
- (4) **Leverage index 1 when it increases**

To calculate the relative fraud indicating Z-Score the following formula should be use:

$$\mathbf{Z} = -4,5 + (0,03 \times R1) + (0,15 \times R2) - (0,17 \times R3) + (4,23 \times R4)$$

Taking into consideration the following the following zone of discrimination:

- Average Z - score for manipulators = 0,20
- Average Z - score for non manipulators = -0,24

VARIABLES (non weighted)			2013	2012	2011	2010
	Average for manipulators	Average for non-manipulators				
Receivables Index (R1)	1,39	1,34	2,214	0,965	0,236	0,822
Inventories Index (R2)	1,23	1,15	0,339	0,229	n/a	n/a
Depreciation Index (R3)	1,03	1,08	0,688	1,385	0,960	0,566
Leverage Index (R4)	1,10	1,00	1,341	0,801	0,720	0,915

Variables weighted		2013	2012	2011	2010
<i>weights</i>					
Receivables Index (R1)	0,003	0,007	0,003	0,001	0,002
Inventories Index (R2)	0,150	0,051	0,034		
Depreciation Index (R3)	0,170	0,117	0,235	0,163	0,096
Leverage Index (R4)	4,230	5,673	3,390	3,045	3,872
constant		-4,500	-4,500	-4,500	-4,500
Total Vladu - Amat Z- Score		1,114	-1,308	-1,617	-0,721

Average Z-score for manipulators = 0,20 ; Average Z-score for non-manipulators = - 0,24

Figure 9. Z-Score of Vladu – Amat – Cuzdrorien Model for GOWEX 2013-2010.

As we can in figure 9, Gowex shows the red flags in all the variables (besides inventories, which are insignificant in that type of companies). It is particularly true in “Depreciation Index” which indicates the warning signals in 2013, 2011 and 2010. The total score of this model considers Gowex as a manipulator in 2013.

7. Nonfinancial methods of account manipulation detection

7.1. Nonfinancial model of Brazel

Easy but effective measure of the financial report reliability is **the comparison between the sales growth and employees’ growth** according to the formula of Brazel (Brazel *et al.* 2009):

$$\text{Employee Diff } t = \text{Revenue Growth I} - \text{N}^\circ \text{ employee Growth I}$$

where:

$$\text{Revenue Growth } I = (\text{Revenue } t - \text{Revenue } t-1) / \text{Revenue } t-1$$

$$\text{Employee growth} = (\text{N}^\circ \text{ employee } t - \text{n}^\circ \text{ employee } t-1) / \text{n}^\circ \text{ employee } t-1$$

See this data in Gowex case in figure 10.

GOVEX DATA	2013	2012	2011	2010	2009
Revenue (€)	182.623.093	114.335.502	66.697.902	49.640.989	35.179.613
Employee (numbers)	127	70	50	36	23

Figure 10. Revenue vs number of Employees in Gowex.

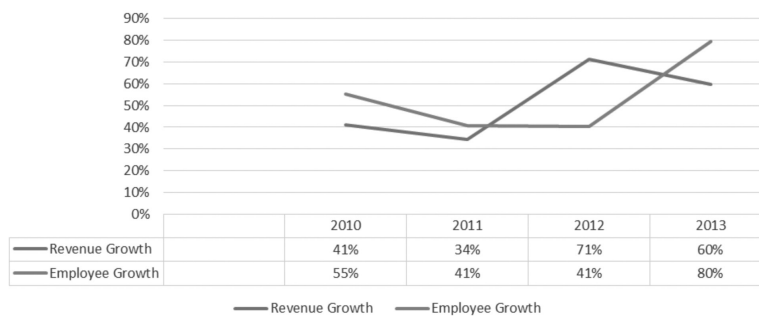


Figure 11. Revenue's and Employee's growth in Gowex.

Figure 11 shows how **unusual relationship** there is **between the growth of revenue and the growth of employees**. The trend is different in different years: in 2012, the Growth of Revenue is much higher than the growth of employees. However, in 2013 the trend is opposite.

Next step requested by Brazil Model is to **compare the above findings with competitors**. One of the Gowex competitors is Towerstream (figure 12 and figure 13).

TOWERSTREAM DATA	2013	2012	2011	2010	2009
Revenue (US \$)	33.433.284	32.279.430	26.494.737	19.645.893	14.915.435
Employee (numbers)	159	173	161	131	131

Figure 12. Revenues versus Number of Employee in Towerstream.

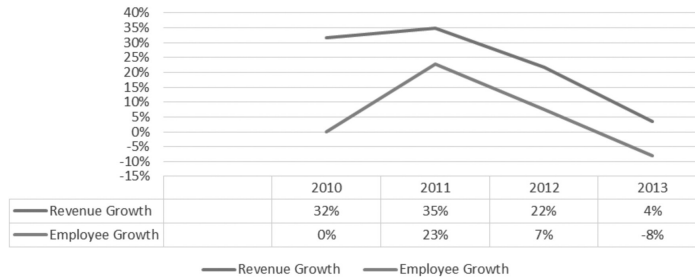


Figure 13. Revenue and employee growth in Towerstream.

As we can see, the trend of the two variables, in Towerstream, is consistent, which once again confirms the anomalies in Gowex.

7.2. Audit fees and auditors reliability

Another possible nonfinancial measure is the comparison the **audit fee as a % of revenues**.

In fact, the most striking abnormality between Gowex and its peers is the amount of audit fees the company has been paying over the examined periods (see figure 14). Gotham City Research found out that Gowex pays 1/10th to 1/20th for auditing of what their peers pay (Gotham City Research LLC 2014). This competitor comparison is a striking red flag signal for account manipulation of Gowex.

	2009	2010	2011	2012	2013
Boingo			1,80%	1,86%	1,57%
iPass			0,67%	0,84%	0,97%
Ruckus			0,50%	0,84%	0,48%
Gogo				0,46%	0,44%
Towerstream			0,89%	0,70%	n.a
Average			0,77%	0,94%	0,87%
GOWEX	0,07%	0,07%	0,06%	0,05%	0,04%

Source: Gotham Report 2014.

Figure 14. Audit fee as a % of Revenues.

The audit fees are strictly linked with auditors reliability exam. The probability of financial statement manipulations is lower in the case the external auditor represents one of the international network (Big Four). In the case of Gowex an another red flag could be assign after looking at the audit company that audited Gowex’s annual reports. A company is called M.A. Auditors SL, an almost unknown in Spain. Gotham City Research claimed that the auditors worked out of a private apartment and appeared very amateurish. Gowex seemed to be the only publically listed company they were auditing.

Gotham reports : “It is really rare for a company of such a high market value to choose an unknown auditor” (Gotham City Research LLC 2014).

7.3. Customer satisfaction

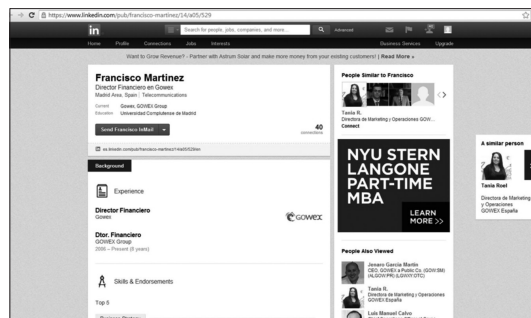
Nowadays, the customer satisfaction becomes very important performance measure.

The customer reviews are publically available online. If investors would have searched the web for reviews, they could have seen that ratings for the Gowex app that come directly from users were quite poor. The users complain that the service is not working at all or that the WI-FI connection is extremely bad. Analyzing all this information it is possible to see that the Gowex does not appear to get a lot of recognition and a new red flag could be considered.

7.4. Competence and integrity of managers

One of the nonfinancial parameters possible to use in fraudulent Financial Statement measuring is the competence and integrity of managers.

Is it true in the Gowex case? CFO of Gowex, Francisco Martinez has a very shady past. In his LinkedIn profil he did not provide any information about him (figure 15):



Source: <https://www.linkedin.com/pub/franciscomartinez/14/a059>

Figure 15. Francisco Martinez, Gowex CFO, LinkedIn profile.

How it is **different**, for example, in the **Boingo's CEO** presentation on Website of company. Then an efficient, reasonable and easy nonfinancial tool to check the reliability of the financial statements has to be the competence and integrity of management and for this parameter we should add to Govex, another red flag.

7.5. Significant transactions with related parties

One of the possible red flag in the fictitious revenues can be a significant transactions with related parties. The Gowex manipulated its results through a complex network of artificial customers. A lot of contracts were simply falsified which is really hard to detect. Nevertheless, what has always been very obvious from the beginning through the offering circular for the IPO in 2010 is that **SeaSunTel was not only Gowex largest customer, but also its largest supplier.**

Client name	Balance at 31/12/08	FY sales
Sea Sun Tel S.L.	8 218 648	12 226 207
Line Informatica, S.L.	1 102 381	3 284 056
As Tic Broker S.L.	1 967 070	1 967 070
Virtual Knowledge Connectivity	522 000	522 000
Intelligent DATA	167040	638000
Comcast Wireless	136 858	136 858
Panel Consulting, S.L.	1 708 723	4 756 133
Ci Netcom Tic Broker Group S.L.	1 566 292	1 566 292
Ricardo Casero Y asociados, Ri	1 332 134	680 000
TOTAL	16 721 146	26 260 792

Suppliers	Balance at 01/01/08	Purchases	Balance at 31/12/08
LINE INFORMATICA	837 659		
Seasuntel, S.L.	7 660 843	15 031 432	2 116 046
Panel consulting	1 380 533		
Ricardo Casero	275 000		175 000
Humania	202 660	765 600	968 260
Bpc 21 Telecommunications E		2 628 524	2 628 524
BTE Y E		2 579 461	2 579 461
Bd Soluciones De Telecomunicaciones, S.L.		2 614 814	2 614 814
L&N World Telecom Broker S.L.		519 744	519 744
F&M Twenty-One Telecom Network, S.L.		518 501	518 501
Knowledge Professional Serv.Co		174 000	174 000
TOTAL	10 356 695	24 832 076	12 294 350

Figure 16. Sea Sun Tel listed as biggest client and one of the biggest suppliers at the same time; source: offering circular, June 2010.

Gotham reports (see figure 16): “Gowex claims to have paid Seasuntel €15 million, and then claims to have earned €12 million from Seasuntel, while being secretly controlled by one of its shareholders. Figure 17 represents the Gowex/Seasuntel transactions resemble round-trip transactions (transactions that lack economic substance)”:

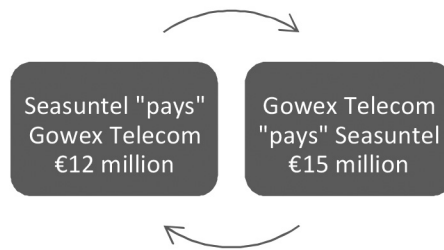


Figure 17. Seasuntel and Gowex relationship diagram.

This relationship created a round-trip transactions and it is a strong warning sign. (Gotham report 2014).

8. Corporate Governance in Spain and Gowex case

The last subject which we should discuss here, is the Corporate Governance rating as a nonfinancial measure for account manipulation. In Spain the first answer to the pionieric Cadbury Report on good corporate governance published in the United Kingdom in 1992, was the **1998 “Olivencia Report”**.

This was the first of the three corporate spanish governance codes. The Olivencia Report recommended that boards have a majority of non-executive directors that safeguards be put in place where the position of chairman and CEO are not separate, that board committees be established, that board meetings be held with appropriate frequency.

Its aim was to “*modernize boards and make them more operational and transparent, so that they serve companies’ interests more effectively*”. Next came the “**Adama Report**” in **2003**, one year after the Sarbana – Oxley Act.

Here the emphasis was on transparency of governance in general (only the boards of directors, the duties of loyalty and care, disclosure of conflicts of interests, the functioning of boards of directors and general meetings, and

the relationship between listed companies and other companies with which they have business relationships or from which they receive advisory service. Lastly, in **2006** came the **Unified Code** for companies that are listed on the Spanish Stock exchanges. This code unified combining the previous two.

In spite of such valid jurisdictional basis in Spain, concerning the Corporate Governance, Gowex had never adopt its recommendations. It was possible as Gowex was listed at MAB where the information about Corporate Governance is not compulsory. Conversely, all aspects of the Gowex governance were in full contraposition of Unified Code recommendations.

First of all, the firm has an poor corporate structure. The board is composed of the CEO García Martín, the CEO's wife, Florencia Mate, and CFO Marugan (Reuters 2014), whose past is quite suspect as there is very little information available about him. In addition to that, Florencia Mate is head of investor relations and the one who is signing off all the annual reports.

Than **no transparency** is given by management. Its Financial Statements are very essential, with small details, some of them are even different comparing English and Spanish version of Financial Statement. If asked about the reason of such opaque company policy CEO of Gowex, Garcia Martin answered with conviction: "There's a Harvard Business Review report saying that opaque businesses work better in the stock exchange than transparent ones."

Due to so **deplorable governance at Gowex**, it makes non sense the comparison with Boingo and Towerstrem who show very high corporate governance level required by USA laws.

9. Conclusions

Our findings concerning the financial data of Gowex confirm that through the control of the institutions, auditors and investors it was possible to find the warning signals about the probability of account manipulation. It is true even for the very simple, essential method regarding the *Financial Statement preliminary analysis*. In Gowex case this simple, traditional tool, reveals its high potential to detect the account manipulation. The findings are sufficiently clear: unusual inconsistencies between sales and account receivables, between expenses and payables, between debts and cash and so on.

The conclusion of this point has two implications. On the one hand, the conclusion could be optimistic: anyone who knows the basic econom-

ical relations can easily find out the reliability of a financial statement. On the other hand, the reflection is rather alarming. **Such easy control was not made by financial institutions, which, in the wholly invented data, found the reason to award Gowex as “The best new listed company”?**

The financial account **manipulation** at Gowex is **confirmed** by two financial measures here applied: M-score **model of Beneish** and Vladu-Amat-Cuzdrorien **Z-score Model**.

The **nonfinancial measures have reveled high effectiveness** in the detection of financial statement manipulations.

All methods used here: “Inconsistency model of Brazel”, Audit fees comparison, Customer satisfaction, Transaction with related parties etc., assign red flags to Gowex and any red flags to its competitors (Towerstream and Boingo).

The same was confirmed by Corporate Governance rating. The governance at Gowex was deplorable, with all aspects contrasting the rules of Unified Code for Spanish listed companies and UE laws recommendations. We wonder why it is possible in Spain, with so good tradition in Corporate Governance regulations, to permit not request this information as mandatory for all listed companies.

In fact Gowex was listed in MaB (Mercado Alternativo Bursatil) which doesn't request this information as mandatory and it is, in our opinion, a grave lack of Spanish law. On the Spanish MAB website (www.bolsasymercados.es) we can read:

“MaB is a market for small companies looking to expand, with a special set of regulations, designed specifically for them with costs and processes tailored to their particular characteristics.”

Now, after the “shocking story” of Gowex, we could read the expression of “*special regulations tailored to their particular characteristics*” with the most worrying meaning.

This “tailored regulations” permit no transparency? The financial data not coherent? a very essential Financial Statement with unrecognizable signatures, as it was possible in the case of Gowex? If it is true, as seems, that means the **MaB wants to protect only the company and not the investors**.

After so **many measures** analyzed here, one seems to be **very essential: the real applications of securities laws** together with proper control of reliability of financial statement by the institutions.

The **increase of awareness of an auditor** about his increasing role for **fraud detection** is another condition. Finally, the **availability of adequate, effective, tools**, which can be used by financial forensic examiner, is necessary to obtain a remarkable success in fraud detections.

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