

COMPLIANCE WEEK

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Hertz Restatement Drives Home Top-Level Control Issues

[Tammy Whitehouse](#) / July 28, 2015

Hertz Corp. has reported the latest chapter in the drama that is its restatement of 2012 and 2013 financial statements. There are plenty of cautionary tales for compliance and audit executives willing to do the reading.

Hertz filed its latest Form 10-K on July 16, and amid news of \$11 billion in revenue and a \$78 million loss for 2014, the auto rental giant also disclosed problems in 15 separate accounting areas going back to 2011. Its investigation tied those problems to extensive control weaknesses, including heavy-handed management applying too much pressure to meet targets and budgets.

When all was said and done, Hertz's restatement erased \$110 million of supposed net income over the years. The company replaced its former CEO Mark Frissora (who now serves as CEO for struggling casino operator Caesars Entertainment Corp.) with current chief executive John Tague. Also gone are the CFO, general counsel, chief accounting officer, and more than 20 other senior-level management and accounting executives.

The company indicates in its 2014 annual report that its internal control over financial reporting still has weaknesses, and PwC disclaims its opinion of internal control as of the end of 2014. Further consequences may still lie ahead as the Securities and Exchange Commission and at least one state regulator continue their own investigations.



Rubenstein

“There are quite a few lessons here,” says David Rubenstein, a partner at audit firm WeiserMazars. “This is textbook. It is almost the requisite recipe for disaster.”

In its filing, Hertz detailed numerous control problems that led to the accounting misstatements. “The company identified control deficiencies related to the control environment, risk assessment, information and communication, and monitoring,” Hertz says. That represents four of the five components of effective internal control as described in the COSO internal control framework, says Bob Hirth, chairman of COSO.

“The company’s incorrect accounting was the result of these control deficiencies and the complete mix of structural and environmental factors,” the 10-K says. The investigation uncovered “inconsistent and sometimes inappropriate” tone at the top, with an emphasis on meeting internal budgets, business plans, and current estimates. “This results in an environment which in some instances may have led to inappropriate accounting decisions and the failure to disclose information critical to an effective review of transactions and accounting entries.”



Hirth

The accounting problems include areas full of judgment, Hirth says. The list includes capitalization and timing of depreciation for certain capital and information technology expenditures; accruals for certain vendor obligations and salvage vehicles; the amortization period on vehicle registration and license fees; reserve estimates around damaged vehicles, doubtful accounts and probable credit card charge backs; accruals for customer rewards programs and unbilled revenue; reserves and accruals associated with Brazil operations; and others.

“This is where you can hide stuff,” Hirth says. “All these reserves, accruals, capitalization, amortization—those are things that can be manipulated because they require judgment.”



Wallis

Dale Wallis, a consultant retired from Aerospace Corp. after 11 years as CFO and treasurer and a member of Financial Executives International, says the extensive description of internal control and accounting problems hits all the notes of the classic fraud triangle. “There was pressure, opportunity, and rationalization,” he says. “They come right out and talk about it in their explanatory note.” The former CEO created pressure to meet targets and budgets, and a weak control environment enabled it to happen, Wallis says.

It serves as a reminder, Wallis says, for boards and especially audit committees to have a good sense on how management goes about its work. “You have to ask good questions and watch for situations where there is undue pressure to meet earnings,” he says.

Given the depth of problems and the company’s own disclosure that its efforts to remediate controls are ongoing, “it wouldn’t completely surprise me if they keep finding more,” Wallis says. While the extent of issues is “disturbing” given how far corporate governance has come since the days of Enron and WorldCom, Wallis is also encouraged that the company reported the issues on its own and remains viable going forward. “This is most interesting for the amount of self-disclosure prior to things completely imploding.”

Let It All Hang Out



Zack

Gerry Zack, managing director in the global forensics group for BDO Consulting, says the directness of the disclosures is unusual. “They don’t beat around the bush,” he says. “They really very specifically call out the former CEO as the leading cause of the restatement. You don’t see that often.”

The disclosures can serve as a teaching case to other companies, Zack says, about the importance of paying close attention to the broader, higher-level controls that are sometimes hard to define and assess.

“This is just a hunch on my part, but it does seem that auditors are more apt to point out the transaction-specific control deficiencies than these higher-level deficiencies,” he says. “I’m trying to picture an auditor going out to management and saying your tone at the top is terrible. They have a harder time saying that. It’s a more intangible type of weakness. There’s much more judgment involved. It raises the question of where does one cross the line between acceptable tone at the top and bad tone at the top?”



Rostan

It’s also a lesson on the importance of investing in strong competence in the accounting staff to assure they know enough about Generally Accepted Accounting Principles to recognize where pressure on estimates may be getting excessive, says Robert Rostan, CEO at Training The Street. “This is a classic case of underinvestment in people and process,” he says.



Richtermeyer

Sandra Richtermeyer, accounting professor at Xavier University and a member of the COSO board, says she’s hopeful as companies get deeper into their use of the COSO internal control framework as updated in 2013, they will recognize the importance of top-level controls. “The broader, companywide, general type of controls clearly does play a major role,” she says. “Hertz describes specific problems that link to specific issues, and collectively they point to higher-level broader things. They paint a picture that they had never invested in a good accounting or internal audit department before, and now it’s caught up with them.”

<https://www.complianceweek.com/news/news-article/hertz-restatement-drives-home-top-level-control-issues#.Vbd-sRNViko>