Fraud at Buca di Beppo: *A Villa in Tuscany?*

The IMA® Committee on Ethics and Raef Lawson, CMA, CFA, CFP, CPA, Ph.D., VP of Research and Professor-in-Residence, are proud to announce that Thomas P. Mihajlov and William F. Miller, CPA, have won the Best Case Award in the sixth annual Carl Menconi Case Writing Competition for their case, "Fraud at Buca di Beppo: A Villa in Tuscany?" The competition is named in memory of Carl Menconi, who held leadership positions in IMA for many years and served as chair of the IMA Committee on Ethics. The objective of the competition is to develop and distribute business ethics cases with specific application to management accounting and finance issues and that use the *IMA Statement of Ethical Professional Practice* as a reference or guidance tool. The winning case and teaching notes are available for use in a classroom or business setting. IMA academic members can access and download the teaching notes from the Academic Teaching Notes library in *LinkUp IMA*. Others who want to use the case and notes should contact Tara Barker at tbarker@imanet.org.

ILLUSTRATION: MARY ZISK/WWW.MARYZISK.COM

By Thomas P. Mihajlov and William F. Miller, CPA

In 1993, a small, successful Minneapolis restaurant company named Parasole Restaurant Holdings, Inc. opened an Italian restaurant named *Buca di Beppo* (or Joe's Basement). In an era when red sauce was a red flag to savvy diners, the restaurant featured a menu with family-style dishes served on huge platters. On weeknights, hour-long waits for tables were common. On weekends, crowds trailed out the door and down the street even during frigid Minnesota winters.

In a short period of time, the company opened more than a dozen Buca di Beppo (Buca) restaurants in five states. In 1996, Buca was spun off from Parasole Restaurant Holdings, Inc., and a professional management team headed by CEO Joseph P. Micatrotto was brought in to lead the company's national expansion. In April 1999, Buca completed its initial public offering (IPO) and was listed on the NASDAQ. Shortly after the IPO, Micatrotto also took on the role of chairman of the board of directors. By the beginning of 2000, Buca was operating more than 40 restaurants in 10 states.

Financial results were impressive. The company's stock jumped more than 50% on its first day of trading. Total revenues for the 12-month period ending July 2000 were \$56.52 million, up 88% from \$30.01 million (which had represented a \$2.49 million loss) for the comparable period of the previous year. Management claimed an improvement in operating margins was the major reason for the positive results: Operating margins were 16.9% for the first half of 2000, compared with 15.3% for the same period of the prior year. New restaurants averaged \$56,000 per week in sales for the year, 25% higher than projected.

Buca continued its steady growth. It opened 17 stores in both 2000 and 2001. In 2002, the company acquired nine Vinny T's restaurants and opened 14 more Buca di Beppo restaurants, for a total of 91 restaurants in 16 states. Total sales increased to more than \$240 million. The company employed more than 7,000 individuals.

Warning Signs

Unfortunately, the financial picture painted for the public was far different from reality. In October 2001, Buca's assistant controller resigned. In a letter to the CFO and Human Resources, he indicated he was resigning because of concerns over the propriety of expense reports, improper related-party transactions, and the manipulation of earnings. No action was taken at the time to make any changes as a result of that letter.

In December 2002, a former employee filed with the Department of Labor for protection under the whistleblower provisions of the Sarbanes-Oxley Act (SOX). The former cash manager of Buca (from 1998 to 2002) claimed he had been fired for reporting accounting irregularities to senior Buca managers, including the improper

Table 1: ***Estimated vs. Reported Earnings per Share (EPS)***

BUCA EARNINGS PRESS RELEASE	DATE OF PRESS RELEASE	EPS ESTIMATES	EPS REPORTED	EPS ESTIMATES MET OR EXCEEDED
Q4 2003	02/09/2004	$0.01	$0.03	YES
Q3 2003	10/22/2003	-$0.11	-$0.12	NO
Q2 2003	07/24/2003	$0.03	$0.03	YES
Q1 2003	04/22/2003	$0.07	$0.07	YES
Q4 2002	02/13/2003	$0.14	$0.14	YES
Q3 2002	10/24/2002	$0.13	$0.07	NO
Q2 2002	07/16/2002	$0.17	$0.17	YES
Q1 2002	04/25/2002	$0.12	$0.13	YES
Q4 2001	01/28/2002	$0.14	$0.16	YES
Q3 2001	10/23/2001	$0.09	$0.09	YES
Q2 2001	07/24/2001	$0.15	$0.15	YES
Q1 2001	04/25/2001	$0.10	$0.11	YES
Q4 2000	02/06/2001	$0.22	$0.23	YES

accounting for employee meals. Buca's senior management made no changes as a result of this allegation and denied the alleged charges.

In June 2003, Buca's controller, current assistant controller, and the director of tax met with the CFO to confront him about the same issues raised in the letter from the assistant controller who resigned in 2001. The CFO assured them that the accounting methods in use were aggressive but legal and acceptable in practice. As in 2001, no actions were taken to change these practices.

In early 2004, the Securities & Exchange Commission (SEC) notified Buca that it was being investigated as a result of the December 2002 whistleblower claim made by the former cash manager.

In May 2004, Micatrotto was forced to resign by the board of directors for apparent personal use of company assets. At the time, the board didn't disclose that he was fired or the true reason for his departure.

On June 7, 2006, the SEC announced the filing of securities charges against three former officers of Buca: Joseph Micatrotto, the former CEO; Greg Gadel, the former CFO; and Daniel J. Skrypek, the former controller. These charges included the receipt of more than $1 million in undisclosed compensation, participation in undisclosed related-party transactions, and financial statement fraud from 2000 to 2004. "Buca's top officers created a tone at the top and a corporate culture that allowed them to loot the company and engage in a financial fraud," Linda Thompson, the SEC's director of enforcement, said. "Such conduct is a fundamental violation of the trust placed in corporate officers by public shareholders and cannot be countenanced." In a stronger statement, Meri Jo Gillette, director of the SEC's Midwest Regional Office, added, "The fraud that prevailed in the executive suite at Buca existed because the company's top officers showed scant regard for sound corporate governance…the Commission will deal with such conduct in the strongest terms."

Accounting Fraud and Accounting Schemes

Micatrotto and Gadel personally orchestrated a scheme to manipulate revenue and net earnings at Buca by overriding internal controls and convincing their subordinates that their actions were legal. Buca's accounting function was highly centralized, which enabled Micatrotto and Gadel, as CEO and CFO, to manage earnings. They insisted on reporting earnings consistent with analyst expectations. Micatrotto regularly told senior managers to "do whatever it takes to make their numbers." As shown in Table 1, Buca reported that its earnings per share met or exceeded analysts' expectations in 11 of the 13 quarters from Q4 2000 through Q4 2003 (with six of the quarters having reported the same EPS as estimated). Unbe-

Table 2: *Revenue Overstatement by Fiscal Year from Employee Meals*

12/26/2000	12/30/2001	12/29/2002	12/28/2003	FIRST 9 MONTHS OF 2004
$2,023,000	$4,349,000	$6,871,000	$7,418,000	$5,040,000

knownst to analysts and other company stakeholders, the reported earnings were far from accurate.

Same-Store Sales

According to the SEC, Buca managed its earnings by manipulating same-store sales figures. Buca management viewed same-store sales as a key indicator and often publicized its reported increases in same-store sales as a measure of company strength and sound financial condition. In addition, part of Micatrotto's and Gadel's bonuses were based on reported same-store sales.

Same-store sales is a common and important metric used in the retail and restaurant industries to measure growth between one year and the next. It involves comparing the sales of stores from one period to the next, and the goal is to gauge how a group of stores is performing from one period to the next and whether sales are increasing or decreasing.

To ensure comparability, sales from new stores are excluded from same-store results. Otherwise, the current-year sales would be higher than the prior year simply because these newer stores didn't have revenue in the prior year. Without that limitation, a company adding a lot of new stores would be showing dramatic increases in aggregate same-store sales. Companies generally exclude sales for any stores not open at least 12 months. Up until at least 2001, Buca followed that practice.

For fiscal year 2000, Buca reported an increase of 6% in same-store sales, following increases of 9.6% in 1999, 13.3% in 1998, and 8.9% in 1997. It also stated its expectation that same-store sales would continue to increase 2% to 4% in fiscal 2001. While the entire restaurant industry saw a dramatic decrease in the number of customers dining out from late 2001 into 2003, Buca's reported results ran contrary to the industry during the same time period.

In reality, Buca's same-store sales began to decline in the first quarter of 2001 and continued to erode further. In response, management made three decisions in 2001 in direct violation of U.S. GAAP (Generally Accepted Accounting Principles). The first was to change when new stores would be included in same-store results. Instead of needing to be open for 12 months before being included, the new period was 18 months. This would hide the fact that new stores weren't performing as well as planned. Changing the measure isn't a direct violation of U.S. GAAP, assuming the reason for the change is justifiable and the change is disclosed. Buca's management didn't disclose the change, nor did it restate prior reported numbers using the new calculation. This resulted in the reporting of higher same-store sales than were actually occurring.

Table 3: *Comparable Restaurant Sales Increase (Decrease)*

FISCAL YEAR ENDING	12/30/2001	12/29/2002	12/28/2003
As Reported	(0.6%)	(2.1%)	(6.9%)
As Restated	(4.1%)	(2.5%)	(6.8%)
Difference	(3.5%)	(0.4%)	(0.1%)
% Difference	583%	19%	1.4%

The second decision was to inflate reported sales by booking revenue from free employee meals. (Each Buca restaurant provided free meals to all employees and their families every afternoon.) The booking of this revenue was in direct violation of U.S. GAAP revenue recognition standards and was material in nature. It resulted in roughly $700 a week in overstated revenue at each store, increasing aggregate sales by $2 million to $7.4 million per year between 2000 and 2003 and more than $5 million in the first nine months of 2004. As one former employee put it, this amounted to having an extra Tuesday night's revenue reported every month.

The third decision was to improperly bill and pay for complimentary meals provided to the corporate headquarters in Minneapolis by one of Buca's stores. Starting in 2001, the store would bill headquarters $1,000 a day for those lunches, and headquarters would pay it. In April or May 2002, that amount was increased to $2,000 per day. This is a clear violation of revenue recognition standards—a business can't sell to itself. While there's no direct impact to net income as a result of this revenue, it overstates total revenue and total expense.

The impact of these decisions would have the largest impact the first year they went into effect. Once Buca implemented these practices, however, it couldn't stop without causing a negative impact on same-store sales. The aggregate impact of these policies on reported revenue and same-store sales can be seen in Tables 2 and 3.

Expense Capitalization

While same-store sales is an important indicator, the changes made by management did nothing to improve the bottom line of the company. To positively impact earnings per share, Buca management elected to capitalize costs that should have been expensed in the period incurred.

Beginning in 2001, at the close of each quarter, Gadel, Buca's CFO, would assess the financial results and determine how much income was needed to meet or beat the expected EPS figures. He would then sit down with Skrypek, the controller, and "find" that income. To do this, they would identify enough ordinary expenses to meet their goal and then reclassify them as fixed assets. This had the direct result of decreasing expenses and increasing earnings by the amount of the newly created assets. Later, capitalization rules were changed to effectively capitalize expenses as they were incurred during the quarter, making it easier to reach whatever shortfall there was at the end of the quarter. The impact of the capitalization on income and earnings per share can be seen in Table 4.

When these practices were disclosed to the public in 2005 and income was restated, Buca admitted that this method was used to capitalize expenses in the following categories: "Pre-operating expenses," "Décor Warehouse and Repair and Maintenance" expenses, certain consulting fees, contributions to the "Annual Paisano Partners" conference, construction management expense, capitalized interest, and certain capitalized costs for technology services, equipment, and maintenance services. As the list suggests, this practice was widespread and included both small and large expenses.

Self-dealings and Personal Gain

In addition to distorting the economic reality of the company, Micatrotto, Gadel, and Skrypek used company assets and their insider knowledge for personal gain.

Theft of Company Assets

Internal controls at Buca were so bad that it was difficult to keep track of outstanding checks. Blank checks were taken and used by top management, and checks were issued without proper documentation. Amounts spent by Micatrotto and Gadel on personal expenses were booked erroneously as valid company expenses or capitalized. For example, the company spent $167,000 for a villa in Italy and another $45,000 for renovations. Yet the villa was titled in Micatrotto's name, not the company's.

According to the SEC, the amount of personal expenses paid on behalf of Micatrotto from 2000 to 2003 totaled approximately $849,100. Buca "reimbursed" Micatrotto for $131,000 in cash withdrawals from ATMs, $127,000

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for airplane tickets submitted multiple times for reimbursement, the entire bill for the groom's dinner at his son's wedding, and other personal expenses, including dog kenneling and the remodeling of his homes in California, Las Vegas, and Minneapolis. These payments weren't reported as additional compensation to Micatrotto as they should have been. As shown in Table 5, Buca's proxy statements for the period understated Micatrotto's annual compensation by 27% to 74%.

Gadel received more than $96,000 in improper compensation for personal expenses, including family vacations, political fundraising, and $30,000 used principally for visits to adult entertainment establishments. In addition, Gadel also had Buca help fund a company called Highwire. Buca had no financial interest in Highwire, but Gadel had a significant financial interest and served as a member of its board of directors. The amount Buca paid to fund Highwire exceeded $1,394,000.

Skrypek arranged for the reimbursement of personal expenses he and Gadel incurred at strip clubs in Minneapolis, Boston, and Puerto Vallarta, Mexico. The largest of these charges was $23,000 for a five-hour visit to a strip club in Boston.

Insider Trading

In June 2002, prior to the announcement of lower-than-

Table 4: *Impact of Improperly Capitalized Expenses on Income and Earnings per Share*

PERIOD	REPORTED NET INCOME	REPORTED NET INCOME PER SHARE	DATE OF PRESS RELEASE	DATE OF SEC FILING	OVERSTATE-MENT OF NET INCOME	OVERSTATED NET INCOME PER SHARE	% OF NET INCOME
FY 2000	$ 7,284,000	$0.54	02/26/01	03/30/01	$2,106,000	$0.16	28.9%
FY 2001	$ 6,818,000	$0.41	01/28/02	04/15/02	$3,934,000	$0.24	57.7%
FY 2002	$ 7,996,000	$0.47	02/13/03	03/17/03	$2,796,000	$0.16	35.0%
Q1 2003	$ 1,098,000	$0.07	04/22/03	05/12/03	$ 394,000	$0.03	35.9%
Q2 2003	$ 427,000	$0.03	07/24/03	08/08/03	$ 469,000	$0.03	109.8%
Q3 2003	($ 2,091,000)	($0.12)	10/22/03	11/12/03	$ 344,000	$0.02	16.5%
Q4 2003	($11,734,000)	($0.70)	02/09/04	03/12/04	$2,622,000	$0.16	22.3%
FY 2003	($12,300,000)	($0.73)	02/09/04	03/12/04	$3,828,000	$0.23	31.1%

Table 5: *Micatrotto Compensation—Reported and Actual*

	2000	2001	2002	2003
Compensation as reported	$327,828	$378,985	$691,211	$699,090
Actual compensation	$447,828	$658,485	$948,911	$890,990
Impact of unreported compensation as a percentage of reported compensation	37%	74%	37%	27%

projected same-store sales, Micatrotto sold more than 43,400 options of Buca stock at approximately $23 a share, netting Micatrotto more than $1 million in cash. This represented the entire number of stock options he held since becoming CEO. Because Buca had a small number of shares outstanding on the NASDAQ, its stock price fell to $13 on the day following this transaction. By July, Buca shares were trading at about $7 a share.

Between 2000 and June 2002, Gadel and Skrypek also used the opportunities presented by manipulated financial results to realize profitable stock market transactions. By exercising options and selling Buca stock, Gadel realized at least $546,000 in profits, and Skrypek made at least $40,027.

Improperly Certified Financials

On March 26, 2003, and March 12, 2004, in accordance with SOX Section 302, Micatrotto and Gadel certified Buca's 2002 and 2003 Forms 10-K. Specifically, Micatrotto and Gadel certified the following:

- They had reviewed the financial report.
- Based on their knowledge, the filings didn't contain any untrue statements of a material fact.
- The statements didn't omit or fail to state a material fact necessary to make the statement misleading.
- To the best of their knowledge, the financial statements and other financial information included in the reports fairly presented in all material respects the financial condition, results of operation, and cash flows of Buca for the periods presented in the annual reports.

Criminal Charges

On June 7, 2006, the SEC filed criminal charges against Joseph P. Micatrotto, Greg A. Gadel, and Daniel J. Skrypek for "presid(ing) over a corporate culture that allowed fraud to flourish" at Buca. At the same time, the U.S. Attorney also filed criminal charges against Micatrotto and Gadel for wire and mail fraud, and the Hennepin County attorney filed theft charges against Skrypek for his receiving reimbursement for personal expenses at several strip clubs.

Micatrotto was charged with seven counts of violating provisions of the Securities Act, the Exchange Act, and/or

SOX. In a separate action, he was charged with four counts of federal mail and wire fraud, which carried criminal penalties. Charges included:

◆ Buca filed several S-8 registration statements with the SEC in connection with the offerings of its securities. These statements, which were incorporated into Buca's financial statements and other SEC filings, were deemed to be part of a scheme by Micatrotto to defraud other investors by making untrue statements of material facts and omitting others regarding his compensation and involvement in two related-party transactions.

◆ Micatrotto used devices, schemes, and other methods to defraud, and he lied about statements of the financial condition of Buca to make it appear to investors and others that such statements were true.

◆ He knowingly implemented (or failed to implement) a system of internal accounting controls at Buca. This had the effect of falsifying Buca's books, records, and accounts. He also lied to or kept facts from accountants and/or independent auditors.

◆ Micatrotto violated SOX Section 302 by certifying Buca's 2002 and 2003 10-Ks when he knew these reports contained false, untrue, and misleading statements of financial facts.

◆ When Micatrotto stood for reelection to the Buca board of directors, he violated Sections 12 and 14(a) of the Exchange Act by misrepresenting his compensation and omitting disclosure of two related-party transactions in Buca's proxy statements for years 2001-2003.

◆ By maintaining a system of internal controls that allowed him to collect a significant amount of unreported compensation and conceal related-party transactions, Micatrotto violated SEC rules and regulations that require the SEC to be kept "reasonably" current with financial information filed in quarterly and annual reports.

◆ Micatrotto failed to develop, implement, and maintain a system of internal controls sufficient to permit the preparation of financial statements in accordance with generally accepted accounting principles.

◆ Micatrotto engaged in two undisclosed related-party transactions.

The SEC charges against Gadel and Skrypek were similar to those against Micatrotto in many cases. Both were actively involved in preparing and ensuring the accuracy of various Buca reports to the SEC and investors, and both had knowledge of and actively participated in the various violations of the Exchange Act and SOX—specifically as they related to the fraudulent preparation and manipulation of financial statements, preparation of proxy statements, related-party transactions involving the villa in Italy, Micatrotto's undisclosed compensation, a "kickback" from vendors, and similar activities.

Under separate actions, Gadel was also charged with federal mail and wire fraud, and Skrypek was charged with theft for his role in gaining improper reimbursement for himself and Gadel for personal expenses.

The Fallout

Buca went public in 1999 at $12 a share. Its price peaked at $26.53 a share in 2001. On the day the guilty pleas of Micatrotto, Gadel, and Skrypek were announced, Buca's stock closed at $5.28. In December 2008, Buca was sold to Planet Hollywood, Inc., for $0.45 a share.

Joseph P. Micatrotto was sentenced to 13 months in federal prison, required to pay more than $565,000 in fines and reimbursements, and banned by the SEC from ever serving as an officer or director of any public company. As part of his departure agreement with Buca, Micatrotto agreed to repay nearly $900,000 in the form of cash and forfeited stock options and transferred ownership of the Italian villa to Buca.

Greg A. Gadel was sentenced to 366 days in prison, fined $50,000, ordered to repay Buca $76,180 for federal mail and wire fraud, and banned by the SEC from ever acting as an accountant or serving as an officer or director of any public company.

Daniel J. Skrypek was fined $50,000, ordered to perform 150 hours of community service, and banned from acting as an accountant, officer, or director of a publicly traded company for a period of five years. **SF**

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Sources for this Case: All of the facts within the article were obtained from publicly available government filings, court documents, news reports, and press releases. The authors have no way of knowing whether the facts contained herein are true on their face; they are a matter of public record.