

Financial Statement Fraud Schemes

Effective expert assistance whether in litigation support consulting, depositions, or prevention requires a thorough knowledge of the nature of financial statement fraud, its purpose and associated red flags. Financial statement fraud does not necessarily lead to immediate losses but is often a means to an end. A common definition is “the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to mislead financial statement users.” Often these schemes can buy more time, comply with loan covenants, obtain loans, or inflate value of equity shares.

Perpetrators of financial statement fraud are looking to gain by encouraging investment of equity stock; hiding negative cash flows; obtaining new or enhanced financing; selling the Company for a higher price; complying with dividend payout and loan covenants and increasing performance related bonuses. These are some of the common goals but are not all-inclusive. By fraudulently improving the financial position or by omitting negative information or contingent liabilities third parties would be more encouraged to buy stock, lend money or otherwise benefit the Company.

Types of Financial Statement Schemes

Following is a discussion of the types of financial statement schemes. Major categories are as follows:

- Fictitious revenues
- Timing differences
- Improper asset valuations
- Concealed liabilities and expenses
- Improper disclosures

This article will focus in detail on fictitious revenues, timing differences and concealed liabilities. Refer to Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) for more discussion of improper asset valuations and improper disclosures.

Fictitious revenues

This can involve fake or phantom customers. The scheme involves using various accounts. For example, Company “A” wishes to record \$100,000 in fictitious sales to a non-existing customer. The initial accounting entry is debit (increase) accounts receivable and credit (decrease) sales for \$100,000. At a similar time, the Company records a debit (increase) fixed assets and credit (decrease) cash for \$100,000. Then the Company records another entry to debit (increase) cash and credit (decrease) accounts receivable for the same amount. Thus, the cash and accounts receivable entries cancel each

other. That leaves the fictitious fixed assets and revenue, one being an asset and the other profit increase. Since fixed assets and revenues usually are significant, amounts these fictitious amounts will go unnoticed unlike cash and accounts receivable. More involved schemes would be to use legitimate customers and inflate or alter invoice to reflect higher than actual amounts. Another form of fictitious revenues involves sales with conditions or terms that have not been completed and rights of risk of ownership have not passed to the purchaser. These are not sales according to generally accepted accounting principles.

Timing Differences

Deliberate recording of revenues or expenses in improper periods is another form of financial statement fraud. This results in increasing or decreasing earnings as desired in certain periods. One of the significant abuses over the years has involved compliance with accounting rules over revenue recognition. Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605 governs the accounting rules in this area. The four criteria are as follows:

1. Persuasive evidence of an arrangement exists;
2. Delivery has occurred or services have been rendered;
3. The seller's price to the buyer is fixed or determinable; and
4. Collectibility is reasonably assured.

Some of the above criteria govern the sales with conditions discussion in the previous section.

Persuasive Evidence of arrangement (following indicates non-existence)

- I. No written or verbal arrangement exists (written is preferred and customary)
- II. A written order is conditional upon sale to end users (i.e. consignment sale) or contains a right of return
- III. A side letter alters the terms of a written arrangement and eliminates the required elements of an agreement

Delivery has not occurred or services have not been rendered

- I. There has not been a shipment and the allowed exceptions such as "bill and hold" transactions have not met the appropriate criteria set out in the FASB ASC.
- II. There has been a shipment but has been shipped to the seller's agent, other representative or to a public warehouse or not all of the components required for operation were shipped.
- III. Some components required for operation were not shipped or items of wrong specification were shipped.
- IV. Shipment delivery is not considered complete until installation, customer testing and customer acceptance has occurred.

- V. Services required under the contract have not been provided or are being performed over an extended period. Therefore only a portion of the service revenues should be recognized in the current period.

The seller's price to the buyer is not fixed or determinable

- I. The sales price is contingent upon some future events.
- II. Fees included are subject to unpredictable cancellation during the contract period.
- III. The transaction includes an option to exchange the product for other products.
- IV. Payment terms are extended for a substantial period and additional discounts and/or upgrades may be required to avoid the buyer discontinuing usage and payments.

Collectability is not reasonably assured

- I. Collection of sale amount is contingent upon a future event. Some examples are resale of the product; litigation or dispute over delivery or receipt of additional funding by the buyer.
- II. The customer does not have the ability to pay. This is measure at time of sale since there can be subsequent events that can affect the customer.

Discussion of revenue recognition

Revenue recognition has been a hot button particularly with the software industry. The SEC has been very concerned in this area due the complexity of the service contracts and the periodic reporting required of public companies. Incorrect revenue recognition has led to numerous restatements often resulting from overstatements of revenue in quarterly and annual reports. Following is a further discussion of the delivery criteria, which is indicative of complexity involved:

Delivery and Performance

As an example of some of the delivery issues, for "multiple element" contracts, if the undelivered elements are essential to the functionality of the delivered element, then the customer does not have full use of the delivered element. If the customer cannot use the product yet because something is incomplete, then generally it is not a sale yet, with the following exceptions:

If the seller meets the criteria for recognizing revenue, except for one undelivered element of the contract, revenue can be recognized on the completed parts only:

If the remaining obligation is inconsequential, the failure to complete the undelivered element would not result in the customer requesting a refund or reject the sale altogether; the costs to complete are minimal and any other vendor readily available can perform the remaining element elsewhere.

For any non-standard product or service customized to buyer specifications, evidence of client acceptance is critical, and usually contractually driven in determining revenue recognition.

Another standard criterion for recognizing revenue is based on title passing during delivery. Enticing “side agreements” can taint the delivery and title process, creating a consignment situation by offering to the buyer, who has accepted title on delivery risk free, interest- free financing or repurchase clauses at essentially the same price. In these cases, revenue should not be recognized until there is a third party sale, despite title passing.

Other revenues, such as an activation fee or a set-up fee, cannot be recognized as revenue separately and must be amortized over the time period of the service provided. A customer does not go to a service provider and sign up for the setup without getting the regular service. They are not separate events.

Concealed liabilities and expenses

Understating liabilities and expenses is one way financial statements make a Company appear more profitable. Missing transactions can be harder to detect than improperly recorded transactions, since the unrecorded transactions leave no recorded audit trail.

Following are three common ways for concealing liabilities and expenses:

- Liability/expense omissions (off balance sheet; not recorded;
- Capitalized expenses (WorldCom example; expensing capital expenses)
- Failure to disclose warranty costs and liabilities

Liability/expense omissions

Not recording liabilities and expenses is probably the easiest method of concealing such items. For example:

- 1) Multi-million dollar legal judgments against a Company are ignored
- 2) Vendor invoices thrown away or stuffed in a drawer instead properly being recorded into the accounts payable system

These transactions if recorded in later periods when actually paid or settled but can be offset by other schemes or profits in these later periods.

Another scheme is to use off balance sheet recording of liabilities. For example in 2002, officials of Adelphia a public company, were charged by the SEC with fraudulently excluding over \$2.3 billion in liabilities from its financial statements by hiding them in off balance sheet affiliates. These officials

including its founder and leading officers were ultimately convicted of conspiracy, securities fraud and bank fraud.

Capitalized expenses

If expenditures are capitalized (improperly) as assets instead of expensed during the current period, income and assets are overstated in the financial statements for that period. WorldCom, Inc. is a very significant and famous example of this.

The SEC alleged that from 1999 through early 2002, WorldCom, Inc. misled investors by materially overstated its income it reported in its financial statements by approximately \$9 billion. The fraud was done mainly by two methods:

- i. Improperly released provisions for “line costs” and taxes as a credit to operating expenses
- ii. Also reduced operating expenses by recharacterizing certain expenses as capital assets
- iii. Total improper accounting approximated \$9 billion and most of this was for “line costs” a major operating expense

The line costs were traditional operating expenses of the telecom industry and WorldCom, Inc. Not only was it materially inconsistent with prior year financials but it had no basis in neither accounting principles nor industry standards. The CEO and CFO were ultimately convicted of conspiracy, securities fraud and false regulatory filings. The CEO was sentenced to 25 years in prison.

Warning Signs (red flags) of financial statement fraud of all types

- Domination of management by a single person or small group without compensating controls
- Overly optimistic press releases or annual report messages
- Recurring negative cash flows
- Recurring attempts to justify marginal or inappropriate accounting on the basis of materiality
- Restrictions on auditors that limit access to people or information
- Rapid growth of revenues or unusual profitability
- Unusual complex transactions
- Significant related party transactions

Additionally for the areas covered in this article, look for the following red flags:

Fictitious revenues:

- a) Unusual growth in day's sale in receivables;
- b) Significant volume of sales to entities whose substance and ownership is not known and
- c) Sales recorded by corporate headquarters.

Timing differences:

- a) Unusual increase in gross margin or gross margin in excess of industry peers;
- b) Unusual growth in day's sales in receivables; or purchases in accounts payable ratios.

Concealed liabilities and expenses:

- a) Assets, liabilities, revenues or expenses based on significant estimates;
- b) Unusual increase in gross margin etc. in excess of peers and
- c) Unusual financial ratios.

Use of ratios to detect possible financial statement fraud

Use of typical financial statement ratios used by auditors and analysts:

- Vertical analysis is the expression of the percentage of component items to a specific base item. Commonly sales are the base item. For example, a comparison is made of purchases as a percentage of sales to historical averages. This could potentially uncover understatement of costs of sales.
- Horizontal statement analysis uses the percentage comparison from one accounting period to the next for a statement line item. For example, percentage change in sales compared to percentage change in related variable expenses such as cost of sales for the different periods reviewed.

Common financial ratios

- Current ratio calculated as current assets divided by current liabilities.
- Quick ratio calculated as liquid assets (cash, marketable securities and receivables) divided by current liabilities.
- Receivable turnover calculated as net sales for a period divided by average net receivables for the same period.
- Inventory turnover calculated as cost of goods sold for a period divided by average inventory balance for the same period.
- Debt to equity calculated as total liabilities divided by total equity.
- Profit margins calculated as net income for a period divided by net sales for the same period.
- Asset turnover calculated as net sales for a period divided by average assets for the same period.

The above ratios are useful to third parties, forensic experts and are often included in loan agreements as defaults covenants. The important factor is to look at the measured results and compare to expectations as well as historical results. Unexplained anomalies could be a sign of financial statement fraud.

Conclusion

The use of an expert particularly a Certified Public Accountant with a financial audit background would be extremely beneficial in cases involving potential or alleged financial statement fraud. For publically held entities, usually (but not always) the records are in better shape and the financial statements a matter of public record. For private entities, it is critical to get a financial expert involved as early as possible since the record keeping and extent of internal accounting skills are not as strong and internal controls are by nature not as extensive.

In any event, the skills of a seasoned CPA are invaluable in investigating financial statement fraud in an efficient and professional manner. They are able to read and quickly understand published financial statements and utilize ratios and other analysis when investigating financial statement fraud.

Additionally Companies can take steps to prevent financial statement fraud by utilizing a strong internal audit function and setting policies and procedures, which will:

- a. Reduce situational pressures that encourage fraud
- b. Reduce the opportunity to commit fraud
- c. Reduce the rationalization of fraud by encouraging employee personal integrity