

Financial Fraud Prevention & Detection

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This discussion primarily pertains to financial statement fraud--that is, financial statements that contain intentionally, or, in some circumstances, recklessly, false statements or entries designed to deceptively enhance the company's financial picture. Internal accounting controls may not always be sufficient, but they are the first line of defense in preventing and detecting fraud.

About The Author

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Typical Means By Which Fraud Is Perpetrated

Financial statements are often fraudulently enhanced by one or a combination of the following means: (1) reduce liabilities, (2) increase assets, (3) increase revenues, (4) reduce expenses, or (5) reclassify assets or liabilities as being long-term or short-term. The discussion in this paper assumes the person perpetrating a fraud will be attempting to enhance the financial statements. However, in some circumstances, the objective of the perpetrator may be to degrade the financial statements--for example, when the amount of a payment or liability due is based on the financial status of the enterprise and will be favorably reduced when that status is diminished. Many of the discussion in this paper are also useful for detecting fraud when the objective is to degrade the financial statements. In that circumstance, you need merely to reverse the emphasis of the method of detection. For example, one means of enhancing financial statements is to reduce cost of goods sold by increasing ending inventory. The reverse would be a means of degrading the financial statements--that is, an increase in the cost of goods sold would degrade the financial statements. Such an increase could be accomplished by reducing ending inventory, possibly by consignments.

There are also means of enhancing financial statements that arguably may not constitute fraud. Examples may include smoothing (i.e., managing the financial numbers

to obtain a steady rate of growth); grouping accounts, transactions, or financial amounts in a manner that tends to obscure or hide the individual components of the group; or recording transactions or amounts in improper accounts for concealment purposes. Fraud is a legal term generally requiring (1) a misrepresentation, concealment, or nondisclosure by the person perpetrating the fraud; (2) the defrauding person's knowledge of or reckless disregard for the fraudulent conduct (e.g., knowledge of the falsity or reckless disregard for the truth of the matter); (3) the defrauding person's intent to induce reliance upon the conduct; (4) justifiable reliance on the fraud by the defrauded person or the market in general; and (5) damages suffered by the defrauded person. Thus, it is possible that in certain circumstances (e.g., when knowledge or reckless disregard of the fraudulent conduct is evident) conduct such as smoothing could be considered fraudulent.

Every financial statement account is susceptible to fraudulent enhancement. However, in practice, a perpetrator probably would attempt to enhance financial statements by the following means: (1) by affecting income statement revenue or expense accounts to increase net income; (2) by increasing assets or reducing liabilities to enhance the overall balance sheet picture; or (3) by reclassifying long- or short-term assets or liabilities to enhance the current asset or net current asset portion of the balance sheet.

The following is a representative, but not exhaustive, list of the balance sheet and income statement accounts and related possible means of fraudulent enhancement.

1. Cash

- a. Delaying until the next accounting period the recording of disbursements made near but before the balance sheet date.
- b. Recording amounts received or expected to be received in the next accounting period as being received in the current period.
- c. Fabricating fictitious cash items, such as bank accounts, transactions, or entries.
- d. Not disclosing that certain cash accounts are in some manner restricted.
- e. Classifying long-term cash accounts as current assets.

2. Accounts Receivable

- a. Fabricating fictitious sales invoices.
- b. Reporting goods on consignment as sales.

- c. Over billing for merchandise sold.
- d. Invoicing/shipping merchandise that was not purchased.
- e. Failing to recognize or disclose the value of return rights or contingent liabilities on sales that contain those rights.
- f. Underestimating the allowance for bad accounts or returns.
- g. Unreasonably lowering required credit qualifications to increase sales. This action would also affect the allowance for bad accounts or returns.
- h. Factoring receivables with recourse, but not recognizing an appropriate contingent liability for the recourse.
- i. Over reporting receivables arising from sales to affiliates. For consolidated financial statements, intercompany receivables should be eliminated. Even if the elimination of affiliate or intercompany receivables is not required, those receivables may not have arisen from actual sales or arm's-length transactions; that is, valuations of those transactions may be suspect.
- j. Extending or modifying receivable due dates or terms without making necessary disclosures or recognizing an appropriate valuation loss.
- k. Reclassifying long-term receivables as current receivables.
- l. Recognizing revenue when the revenue-generating process is not yet complete (e.g., the collection of the sales price is not reasonably assured).
- m. Recognizing revenue from "sales" of merchandise to customers but holding or warehousing the merchandise for later use by the customer and delaying billing--essentially, preselling merchandise.
- n. Carrying as receivables amounts due from related parties (e.g., subsidiaries) when there is no expectation of payment or delay in payment is expected.
- o. Recognizing revenue from installment sales prior to the appropriate period.

3. Inventory

- a. Overvaluing existing inventory.
- b. Counting nonexistent inventory or sold merchandise that is being warehoused for customers.
- c. Not reducing the value of obsolete, damaged, or slow-moving inventory.
- d. Improperly changing or disclosing a change in inventory accounting methods.
- e. Failing to disclose pledged inventory when required.
- f. Reclassifying old and new inventory to alter valuation under the inventory accounting conventions (e.g., under the LIFO and FIFO inventory methods).
- g. Counting inventory sold and warehoused under a repurchase agreement.

4. Property, Plant, And Equipment

- a. Recording expenses as acquisitions of property, plant, and equipment to delay recognizing the entire immediate expense.
- b. Reducing or delaying depreciation.
- c. Recording inflated property, plant, and equipment values (e.g., recording those assets at fictitious values or at appraised value instead of cost value).
- d. In a purchase of multiple assets, allocating the purchase price to property, plant, and equipment as opposed to short-term assets such as inventory so as to write-off expenses over a longer period of time.
- e. In a purchase of multiple assets, reducing values allocated to tangible assets so as to increase goodwill, which can be amortized over a longer period of time.

5. Investments/Securities

- a. Overvaluing investments or securities--assigning an excessive value when no readily available market determines the value or, in the case of transactions with related parties (e.g., in an asset for stock transaction), overvaluing the asset to allow overvaluation of the stock.
- b. Reclassifying long-term investment/security assets as current assets to increase liquidity.
- c. Pledging investments as security without appropriate financial statement disclosure.
- d. Classifying current marketable securities as noncurrent assets to allow an unrealized loss of value to be recorded as a reduction of equity instead of as a reduction of net income. Similarly, for noncurrent marketable securities, improperly classifying an unrealized loss in value as temporary instead of as other than temporary to allow the loss to be recorded as a reduction in equity instead of as a reduction in net income.

6. Taxes

- a. Recording an excessive or insupportable income tax receivable as a liability under Statement of Financial Accounting Standards 109.

7. Leases

- a. Improperly treating a lease as an operating lease (e.g., instead of as a sales lease) in an attempt to avoid recording or disclosing lease payment liabilities.

8. Goodwill

- a. Reducing current expenses by allocating purchase costs to goodwill, which is amortized over a longer period of time.
- b. Paying too much for goodwill to increase assets.
- c. Although not necessarily fraudulent, as with all assets carried at historic cost, the current fair value of goodwill may be less than indicated on the balance sheet because the goodwill may have lost value (e.g., due to changes in the market, product, or the enterprise subsequent to the initial valuation and recording of the goodwill).

9. Intangibles

- a. Overvaluing an intangible (e.g., the allowable value of a patent) to increase total assets.
- b. Similar to goodwill, although not necessarily fraudulent, the current fair value of an intangible may be less than indicated on the balance sheet because the intangible may have lost value (e.g., the market, product, or the enterprise may have changed or become obsolete).
- c. Similar to goodwill, reducing current expenses by allocating costs to an intangible asset, which is amortized over a longer period.

10. Liabilities

- a. Not recognizing or disclosing contingent liabilities.
- b. Improperly treating a sales lease as an operating lease.
- c. Not recognizing or disclosing the value of a right of return with respect to a sale.
- d. Improperly recognizing a sale when the earnings process is not yet complete.
- e. Restructuring or modifying loans or receivables when they become uncollectible without recognizing or disclosing, when required, a related loss in value, contingent liability, or change in terms.
- f. Factoring an asset such as a receivable with recourse but failing to record or disclose the contingent recourse liability.
- g. Recording a loan as receipt of cash and an increase in equity instead of as a liability increase. The enterprise makes the monthly payment by crediting cash and debiting owner's equity, thereby making the monthly payment look like owner drawing and allowing the enterprise not to record the liability.
- h. Improperly classifying a current liability as long-term to improve net current asset value.
- i. Improperly excluding or not describing an off-balance sheet transaction or entity item.

11. Equity

- a. Recording a loan from the owners as equity and payments on the loan as owner withdrawals. The list of possible abuses of the equity account is almost endless. Thus, all significant changes in the equity account should be reconciled to determine that they are in fact not more appropriately classified as entries affecting other balance sheet or income statement accounts.

12. Revenues/Gains

- a. Recognizing revenues from sales for which the earning process is not yet complete (e.g., collection of the sales price is not reasonably assured).
- b. Recognizing unearned revenues before appropriate.
- c. Recognizing revenues in the current period for sales that will occur in the following period.
- d. Failing to recognize the value of a right of return or repurchase obligation with respect to sales that contain those terms.
- e. Classifying nonoperating or extraordinary revenues or gains as operating.
- f. Inflating revenues from sales to related parties, affiliates, or subsidiaries (e.g., by reporting fictitious sales, overvaluing sales amounts, or not eliminating intercompany transactions in consolidated financial statements).
- g. Deferring until the following period credit memoranda, sales returns, or allowances that are attributable to the current period.
- h. Recording consignments as sales.
- i. Increasing sales through unusual circumstances by the use of adjusting or general journal entries.
- j. Fabricating fictitious sales invoices.
- k. Over billing for merchandise sold.

- l. Invoicing/shipping merchandise not purchased.
- m. Underestimating the allowance for bad accounts or returns.
- n. Increasing sales by unreasonably lowering required credit qualifications and not evaluating the adequacy of the allowance for returns.
- o. Recognizing installment sales revenue prior to the appropriate period.
- p. Recognizing revenue from "sales" to customers, but holding or warehousing the merchandise for later use with a corresponding delayed billing.
- q. Recognizing currency translation gains from foreign operations as income instead of as a separate component of equity.
- r. Failing to properly disclose or account for a change in accounting method, change to an improper accounting method, or improperly changing to an accounting method that is otherwise acceptable but that is not a preferred method when compared to the method currently in use.

13. Cost Of Goods Sold

- a. Overvaluing ending inventory to reduce cost of goods sold, resulting in higher net income.
- b. Counting nonexistent inventory.
- c. Not reducing the value of obsolete, damaged, or slow-moving inventory.
- d. Counting inventory sold but warehoused for customers.
- e. Reclassifying old and new inventory to alter valuation under the inventory accounting conventions (e.g., under the LIFO and FIFO inventory methods).
- f. Counting inventory sold and warehoused under a repurchase agreement.
- g. Counting inventory consigned to the enterprise, or inventory

received from an affiliate but not owned by the enterprise.

14. Expenses

- a. Recording an expense as a prepaid expense, an asset with a usefulness extending beyond the end of the current fiscal year, thereby reducing or delaying current period charge-off to future periods.
- b. Delaying until the next accounting period the recording of disbursements made near but before the balance sheet date.
- c. Recording current expenses as acquisitions of property, plant, and equipment, thereby deferring or eliminating the expense.
- d. Reducing or delaying depreciation.
- e. In a purchase of multiple assets, allocating the purchase price to property, plant, and equipment as opposed to short-term assets such as inventory so as to write-off expenses over a longer period of time.
- f. In a purchase of multiple assets, reducing values allocated to tangible assets so as to increase goodwill, which can be amortized over a longer period of time.
- g. Not recognizing or disclosing liability contingencies.
- h. Not recognizing or disclosing the value of a right of return with respect to a sale.
- i. Recording a loan as a receipt of cash and an increase in equity instead of as a liability increase. The enterprise makes the monthly payment by crediting cash and debiting owner's equity, thereby making the monthly payment look like owner drawing and allowing the company not to record the liability.

15. Pension Plans

- a. Pension plans are accounted for as independent entities separate from the general enterprise accounting records and financial statements. It is not within the scope of this paper to discuss accounting principles for pension plans. However, although not necessarily related to fraudulent practices, analysis of the financial

statement of a company may also include analysis of the financial statement disclosure notes pertaining to the company's pension plan liabilities, including various past and current costs or liabilities, unrealized gains and losses, types of investments, and asset fair valuation. Department of Labor random reviews of employee benefit plan audits reveal that a percentage of plans do not comply with Generally Accepted Auditing Standards and Employee Retirement Income Security Act requirements.

Detecting Fraud

Internal accounting controls are the primary means of detecting and preventing fraud. Of course, it becomes more difficult to detect or prevent fraud when two or more employees become joint perpetrators or when a lower-level employee, such as a mid-level manager, allows improprieties by senior-level person out of a fear of reprisal. Fraudulent conduct is not limited to senior personnel--it is not unusual for mid- or lower-level personnel to perpetrate fraud to achieve company growth objectives, advancement, or recognition, or to conceal failures or mistakes.

The following is a listing of some of the means of detecting fraud, including potential warning signals.

1. Analyze the integrity of management. Is management honest, cooperative, not overly egotistic, and willing to work with others? Does management set reasonable objectives? Is there a propensity to obtain desired results at all costs? Is undue pressure placed on personnel to achieve management's goals? Does the company have a mechanism for allowing employees to report improprieties or to make suggestions of improvement, in confidence if necessary? Is compensation unreasonably tied to the performance results of the company?

2. Does the company have a reliable accounting department and internal control system, and an appropriately trained and staffed internal audit department that has sufficient authority to perform its function? Does the internal audit function work with senior management, and also independently report to the directors? The audit committee may consider reviewing internal audit employment hiring and terminations. Does the audit committee diligently oversee the internal audit function, and internal controls? Does the company have a compliance and ethic function and/or a governance, risk and compliance function, who oversees the function and integrates the function with corporate activities, and does the audit committee sufficiently interact with the function?

3. Does the audit committee seek to obtain independent auditors (including the lower-level staff accountants of the independent auditors) who are knowledgeable about the company and who understand the company's desire not just to obtain a "clean" audit opinion but also to constantly improve the internal control system, keeping in mind cost-

benefit considerations? The audit committee may consider obtaining comments from the lower-level auditors about the conduct of the company's employees during the course of the audit.

4. Analyze the practices and trends in the industry as compared to the practices and trends of the company. Is the company highly visible? Is there an impression that the company is a high flier such that less than extraordinary results would be considered disappointing? Is the company experiencing unusual profits, growth, or losses? Are the company and its primary areas of business on solid financial and business grounds?

5. Material fraud often is exposed by analytic analysis of changes in financial information, account balances, and significant financial ratios between different accounting periods. Significant changes should be investigated in detail. Analytic analysis should be performed on a company comparison basis; that is, by comparing current company financial information with similar prior financial information of that same company, and by comparing the company to industry averages and trends and other similarly situated companies. Although cost benefit should be kept in mind, such an analysis can also be done at the department level on small accounts. The following are some of the key ratios that may be considered for fraud analysis. Most of the ratios are also useful for general financial analysis and budgeting.

- a. Sales or revenues compared to cost of goods sold.
- b. Sales or revenues compared to assets or investments.
- c. Gross sales or revenues compared to returns and credits.
- d. Sales or revenues compared to average inventory.
- e. Sales or revenues compared to average receivables.
- f. Average receivables compared to sales per day.
- g. Current assets compared to current liabilities.
- h. Reserve for uncollectible receivables compared to receivables.
- i. Cash plus cash equivalent current assets compared to current liabilities.
- j. Total debt compared to total assets.
- k. Profit or income compared to net worth, assets, sales, or revenues.

1. Earnings compared to interest expense.

6. Statement of cash flows ratio analysis should be considered, but often might not be utilized. The statement of cash flows presents changes in actual cash accounts during a period of time, as opposed to the income statement, which accrues income and expenses although actual cash may not have been received or disbursed. Thus, the statement of cash flows is useful to management as an indicator of a company's ability to generate actual cash to pay debts and dividends or meet operating cash needs. With respect to financial statement fraud, the statement of cash flows may be useful as an indicator of the company's going concern status--that is, an indicator of the likelihood of bankruptcy--and to detect unusual changes in sales or inventory. The following may be useful ratios for statement of cash flows analysis:
 - a. Cash from operations compared to sales.
 - b. Cash from operations compared to accounts receivable.
 - c. Cash from operations compared to income from operations.
 - d. Cash from operations compared to inventory.
 - e. Total debt compared to cash from operations.
 - f. Cash from operations compared to debt payments (long- and short-term), operations asset purchases plus dividends paid, and individually, debt payments, asset purchases, and dividends paid compared to cash from operations.

7. Compare the financial statements or other pertinent information to another source that is comparable and more likely to be reliable. For example, tax return information, if available, may be a more reliable indication of sales and expenses than the financial statements because the company would be less inclined to overstate income and understate expenses on its tax return.

8. Determine whether accounts receivable turnover is slowing down or whether accounts receivables are growing faster than sales.

9. Determine whether inventory turnover is slowing down or whether inventories are growing faster than sales.

10. Investigate whether employee turnover is unusually high in any particular department or within an broad authority level, such as mid- or upper-management.

11. Investigate whether the company has a history of changing audit firms, has

recently changed audit firms, or has had disputes with its auditors.

12. Investigate transactions with related parties, subsidiaries, or affiliates.
13. Determine whether the company engages in transactions that require appraisals or valuations for reporting purposes.
14. Investigate whether insider purchases or sales of the corporation's securities are unusually high or low.
15. Determine whether the company has adequate working capital.
16. Determine whether the quality of receivables is deteriorating based on an aging of receivables.
17. Determine whether inventories are increasing in comparison to normal cost of goods sold ratios.
18. Have sales incentive programs become unreasonably liberal?
19. Have sales returns or credits increased, especially after the end of the accounting period?
20. Investigate the company's off-balance-sheet financing.
21. Determine whether the company is engaged in an industry area that is, or has assets that are highly susceptible to contingent liabilities.

Conclusion

Properly enacted and functioning internal accounting controls, along with an understanding of some of the means of perpetrating and analytically detecting financial statement fraud will in most circumstances deter and prevent the occurrence of fraudulent financial statements. Significant financial statement fraud seldom goes undetected for an extended period of time.

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