THE CHANGING PATTERNS OF FINANCIAL STATEMENT FRAUD

DEFINITIONS

Financial statement frauds is the *deliberate misrepresentation* of the financial conditions of an enterprise accomplished through the *intentional misstatement* or *omission* of amounts or disclosures in the financial statements to *deceive* financial statement users.

CAUSES OF FINANCIAL STATEMENTS FRAUD

Motivation for financial fraud does not always involve direct personal financial gain. The cause of financial statement fraud is;

- Situational pressure on the manager or company.
- Opportunity to commit fraud.

SITUATIONAL PRESSURES

Sudden decrease in revenue by a company or industry

Financial pressures resulting from bonus plans that depend on short-term economic performance

Unrealistic budget pressures particularly for shot term results

OPPORTUNITY

- Absence of a board of directors or audit committees
- Weak board of directors
- Weak or no-existent internal controls
- Ineffective internal audit staff and lack of external audits
- Unusual or complex transactions
- Financial estimates that require significant subjective judgment by management

WHY? DO IT

We “cook the books” to “buy more time”. The main reasons are;

- To quietly fix current problems
- To obtain or renew financing
- To inflate company share prices or exercise stock options at a profit
- To obtain bonus pay linked to company performance

WHY? DO IT.

- To encourage investment through the sale of stock
- To demonstrate increased earnings per share thus allowing increased dividend payouts
- To cover inability to generate cash flow
- To dispel negative market perceptions
- To receive higher purchase prices for acquisitions
- To demonstrate compliance with financing covenants
- To meet company goals and objectives

How to do it

FINANCIAL STATEMENT FRAUD SCHEMES

FORMS OF FINANCIAL STATEMENT FRAUD SCHEMES

1. Overstated assets or revenues

2. Understated liabilities and expenses

CLASSIFFICATION OF FINANCIAL STATEMENT FRAUD SCHEMES

The five classifications of financial statement fraud schemes are;

1. Fictitious revenues
2. Timing differences
3. Improper asset valuations
4. Concealed liabilities and expenses
5. Improper disclosures

Financial statement frauds will entail a combination of these schemes.

FICTITIOUS REVENUES

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Recording of sales of goods that did not occur. This sale is reversed in the next accounting period.

Sales with conditions.

These are sales where ownership has not passed to the customer. They do not qualify for recording as revenue.

RED FLAGS OF FICTITIOUS REVENUES

1. Rapid growth or unusual profitability as compared to similar companies in the industry
2. Recurring negative cash flows or an inability to generate positive cashflows while reporting earnings and earnings growth.
3. Significant transactions with related parties
4. Special purpose entities not in the ordinary course of business
5. Significant unusual, or complex transactions especially close to the periods end that pose difficult “substance over form” questions.
6. Unusual growth in debtors days analysis
7. A significant sale to shell companies

TIMING DIFFERENCES (INCLUDING PRE-MATURE REVENUE RECOGNITION)

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Recording of expenses or revenues in improper periods. Areas to look at on the above are;

- Long term contracts
- Channel stuffing
- Recording expenses in the wrong period

IMPROPER ASSET VALUATIONS

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Improper asset valuation take the form of one of the following classifications;

- Inventory valuations
- Accounts receivable
- Business combinations
- Fixed assets

INVENTORY VALUATIONS

Inventory should be recorded at the lower of cost or market value. Other methods include;

- Manipulation of the physical inventory count
- Inflation of the unit costs used to price out inventories
- Creation of fictitious inventory e.g. manipulated stock count sheets
- Reported large values of inventory in transit
- Inventory with hollow centers
- Shuttled inventory overnight from one warehouse to the other

ACCOUNTS RECEIVABLE

Fictitious accounts receivable, these are common with companies with financial problems or from managers who receive commissions on sales.

Failure to write of bad debts and to make provisions for bad debts.

FIXED ASSETS

Recording fictitious assets by increasing assets and increasing owners equity.

Creating fictitious documents.

Recording leased assets as company owned assets.

Misrepresenting the value of fixed assets- recording fixed assets at market value.

FIXED ASSETS-SCHEMES

- Capitalising non-current assets
- Understate fixed assets-common in Government entities
- Misclassifying assets-reporting fixed assets as current assets, for loan / liquidity purposes

CONCEALED LIABILITIES AND EXPENSES

COMMON METHODS

- Liability/expense omissions
- Capitalised expenses

LIABILITY/EXPENSE OMISSIONS

- Failure to post invoices
- Creating fictitious debit notes

This is the easiest scheme to perpetrate and the hardest for debtors to detect.

Example is Adelphia Communications Corporation (Adelphia) failed to report over US$2.3Billion in liabilities.

CAPITALISED EXPENSES

Capitalised expenses increases income and increases assets in the current accounting period. These expenses are then written-off over several years reducing future incomes.eg WorldCom.

EXPENSING CAPITAL EXPENDITURE

This is done for purposes of reducing income thus reducing taxes.

IMPROPER DISCLOSURES

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Financial statements should include all necessary information to prevent any stake holder from being misled the schemes here are;

- Liability omissions-failure to disclose loan covenants or contingent liabilities
- Subsequent events-failure to disclose court judgments'
- Related-party transactions e.g. Tyco International Ltd
- Accounting changes
- Failure to disclose unclaimed financial assets

RED FLAGS ASSOCIATED WITH IMPROPER DISCLOSURES

- Domination of management by a single person or a small group.
- Ineffective board of directors or audit committee oversight over financial statements
- Lack of organisation code of ethics
- Formal or informal restrictions to the external auditor that limits them access to people and information.
- Complex organisational structure
- Significant bank accounts or branch activities in tax haven jurisdictions' which there appears to be no clear business justifications.

FINANCIAL STATEMENT ANALYSIS

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Financial statement analysis is done to detect major changes in financial statements so as to detect frauds. Major changes in the financial statements may indicate red flags in the financial statements. The main analysis to be made are;

- Vertical analysis
- Horizontal analysis
- Ratio analysis

RANKING OF RISKS

All financial statement frauds are considered to be high risks.

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Open Discussion

QUESTIONS

Services Offered

- Internal audit
- Fraud Risk Assessment
- Forensic Investigations
- Fraud Training & Awareness Programs
- Anti-money Laundering
- Pre-employment Integrity interviews
- Loss Prevention Consulting
- Dispute Advisory
- Due Diligence Investigations
- Background Screenings
- Unclaimed Financial Assets compliance and reporting audits

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