Finacial Statement Fraud

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What is FSF

- Falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions

- Material intentional omissions or misrepresentations of events, transactions, accounts, or other significant information from which financial statements are prepared

- Deliberate misapplication of accounting principles, policies, and procedures used to measure, recognize, report, and disclose economic events and business transactions

- Intentional omissions of disclosures or presentation of inadequate disclosures regarding accounting principles and policies and related financial amounts

Effects of FSF

- Undermines the reliability, quality, transparency, and integrity of the financial reporting process
- Jeopardizes the integrity and objectivity of the auditing profession, especially auditors and auditing firms
- Diminishes the confidence of the capital markets, as well as market participants, in the reliability of financial information
- Makes the capital markets less efficient

Who is the culprit

- Senior management
- Mid- and lower-level employees
- Organized criminals

Who commits FSF

- Public and private businesses commit financial statement fraud to

- **Secure investor interest or**
- **Obtain bank approvals for financing,**
- **Justification for bonuses or**
- **increased salaries or**
- **to meet expectations of shareholders**.

- Upper management is usually at the center of financial statement fraud because **financial statements are created at the management level**.

Financial Statements

- Financial Statements are accounting reports that present the financial activity and financial position of a company.

- These reports indicate how money moves in and out of an organization,

- How much money currently sits in a company, and how much the company owes.

- Investors, creditors, potential business partners, and the public rely on the information presented in these statements to make decisions.

What Is a Balance Sheet?

- The balance sheet is a snapshot of a company’s financial position at a particular point in time.
- It outlines what assets a company owns and how much cash it has versus how much debt it has.
- The balance is essentially an expansion of the accounting equation, assets = liabilities + owners’ equity.
- It lists a company’s assets on one side and its liabilities and owners’ equity on the other side. Both sides of the equation must be equal, or “balance.”

What Is a Balance Sheet?
- Assets

- Assets are physical items or rights that have value and are owned by the company.
- They are increased by debits.
- Assets are classified as either current or non-current and are separated as such on the balance sheet.

Current Assets

- Current assets consist of cash or other liquid assets that are expected to be converted to cash or sold or used up, usually within a year or less.

- Current assets listed on the balance sheet example **include cash, accounts receivable, inventory, supplies**, and prepaid expenses.

Non-current Assets

- Noncurrent assets consist of all other assets that will likely be on the books for more than one year.

Examples include property, plant, and equipment; long-term investments (e.g., bonds); and intangibles (e.g., patents and goodwill).

Liabilities

- Liabilities are debts of a business owed to outsiders. They are increased by credits. There are two categories of liabilities:

• Current liabilities are liabilities that are expected to be satisfied within a year.

Some examples are **short-term loans, accounts payable, accrued salaries and benefits, and interest payable**.

• Long-term liabilities are debts that the organization will have on their books for more than a year. Bonds payable, deferred tax liabilities, pension obligations, and leases are all long-term liabilities.

Owners’ Equity

- Owners' equity is often referred to as the book value or the net assets of the company, and it comes from two places:

- Common stock

- Retained earnings

Common Stock

- Common stock is **money that was originally invested in the company**

- Paid-in-capital consists **of any additional investments made thereafter**.

Retained Earnings

- Retained earnings are earnings that the company is able to accumulate over time through its operations.
- This figure is derived from the income statement.
- If the company incurs a loss one period, the loss will reduce the amount of owners’ equity on the balance sheet

Balance Sheet Manipulation

- The balance sheet is a great place to start when investigating a company's records.
- Balance sheets are usually **manipulated by overstating assets or understating liabilities**.

What Is an Income Statement?

- An income statement is a summary of an organization's revenue and expenses over a certain period of time, such as a quarter or a year.

- The income statement is sometimes referred to as the profit and loss (P&L) statement.

- **Two basic types of accounts are reported on the income statement—revenues and expenses.**

Revenue

- The top line of an income statement is a business's earnings, or revenue.
- Revenue is an increase in owners' equity resulting from a company's normal business operations.
- Revenue is primarily generated from the sale of goods or services, but it can also be earned in the form of interest or dividends.
- Revenue is increased by credits. A fraud investigator should be on the **lookout for overstated revenue numbers**.

Cost of Goods Sold

- From sales, an expense called cost of goods sold is deducted.
- Cost of goods sold refers to the inventory costs of the goods a business has sold during a particular period.
- This figure can vary widely depending on which inventory costing method is used
- The method a company elects to use will be disclosed in the footnotes to the financial statements.

Gross Margin

- For a company that manufactures goods, cost of goods sold represents the amount the company spent on materials, labor, and overhead.
- For a merchandise reseller, the expense reflects the amount the company paid for the goods it sells.
- For a service organization, cost of goods sold might reflect salaries paid to employees.
- Sales less cost of goods sold is equal to gross margin.

Operating Expenses

- Operating expenses are the economic costs that a business incurs to support and sustain its business operations to earn revenue.

- Some typical expenses are advertising, salary and wages, rent, utilities, office supplies, and depreciation expense.

- Expenses are increased by debits.

Net Income

- Expenses are subtracted from gross margin to arrive at net income.
- If total expenses exceed total revenues, then the company will report a net loss.
- **A fraudster will commonly understate expenses to give the illusion of more efficient or profitable performance or to avoid having to record a loss**

Net Income

- Net income is money that can be put to two uses:

- Dividends paid to shareholders

- Retained earnings, which is an account that appears on the balance sheet under owners' equity

Income Statement Formula

- Sales Less: Cost of goods sold ..Gross margin
- Less: Operating expenses …Income before taxes
- Less: Taxes .. Net income
- Less: Dividends …Retained earnings → to the balance sheet

What Is a Statement of Cash Flows?

- The statement of cash flows reports the sources of a company's cash inflows and outflows over a specific period of time.

- It indicates a company's ability to generate cash from operations, maintain and expand its operating capacity, meet its financial obligations, and pay dividends.

Statement of cash flows

- Cash inflows and outflows are categorized as follows:
- 1. Cash flows from operating activities
- 2. Cash flows from investing activities 3. Cash flows from financing activities

Cash Flows from Operating Activities

- Cash flows from operating activities come from *transactions that affect net income.*
- Cash inflows included in this category are ***payments received from customers for sales.***
- Cash outflows from operations include *payments to vendors for merchandise and payments to employees for wages*.
- This category is often considered the most important of the three categories of cash flows.

Cash Flows from Investing Activities

- Cash flows from investing activities usually arise from the sale or purchase of fixed assets, investments, or intangible assets.

Cash Flows from Financing Activities

- Cash flows from financing activities come from transactions that affect the equity and debt of the company.
- Cash inflows in this category occur **when a company sells its own stock, issues bonds, or takes out a loan**.
- Cash *outflows* from financing activities include paying cash **dividends to shareholders, acquiring shares of its own stock, and repaying debt.**

Total of net cash flow Cash Flows?

- The total of the net cash flow from these activities is the net *increase or decrease* in cash for the period.

- The cash balance at the beginning of the period is added to the net increase or decrease in cash from the statement of cash flows, and the resulting ending cash balance is reported on the balance sheet.

- The statement of cash flows greatly enhances the financial statement's transparency.

What Is the MD&A?

- The Management's Discussion and Analysis (MD&A) accompanies the financial statements. It is a narrative explanation, through the eyes of management, of how an entity has performed in the past, its current financial condition, and its future prospects.

Putting Together the Statements

- Taken individually, the information on the three financial statements we've discussed might not raise any red flags to a forensic auditor.
- No single financial statement tells the complete story of what is happening in a company.
- It is imperative to look at the financial statements as a whole, and see how they relate to each other, and also how they change over time.

Why corporate executives overstate business performance

- To meet or exceed the earnings or revenue growth expectations of stock market analysts
- To comply with loan agreements
- To increase the amount of financing available from asset-based loans
- To meet a lender’s criteria for granting/extending loan facilities.
- To meet corporate performance criteria set by the parent company

Why corporate executives overstate business performance

- To meet personal performance criteria

- To trigger performance-related compensation or earn-out payments.

- To support the stock price in anticipation of a merger, acquisition, or sale of personal stockholding.

- To show a pattern of growth to support a planned securities offering or sale of the busines

Why corporate executives understate business performance

- To defer “surplus” earnings to the next accounting period.
- To reduce expectations now so future growth will be better perceived and rewarded.
- To reduce the value of an owner-managed business for purposes of a tax settlement.
- To reduce the value of a company whose management is planning a buyout.

Methods

- Financial statement frauds fall into general categories.

  These include :

- Improper revenue recognition,
- Manipulation of liabilities,
- Manipulation of expenses,
- Improper disclosures on financial statements and
- Overstating assets.

Categories

Factitious Revenue

- This occurs when a company records factious sale of goods or services.
- The most common method is simply to record a sale that never occurred or does not exist.
- A second approach is to create a fake invoice for a real customer but not ship the goods or provide the services described in the false invoice.
- A third way is to alter an authentic invoice to reflect a greater shilling amount or quantity than was actually sold.

Categories -**Timing differences**

- Timing differences involve recording of legitimate revenue and /or expenses in improper periods.
- According to GAAP, revenue and corresponding expenses should be recorded in the same accounting period (Referred to as matching principle).
- Due to profitability goal pressures, fraudsters are often motivated to record sales or expenses in the wrong period.
- For example – A company may accurately record sales at the end of year 1, but fail to record some of the expenses associated with those sales until early in year 2
- This overstates net income in year one.

categories

Concealed liabilities

- Concealed liabilities has a positive effect on the balance sheet in that the equity or asset accounts will have to increase by the amount of the understatement in order to keep the books in balance.
- Understating expenses artificially inflates net income, which overstates owner’s equity.
- The most prevalent method of concealing liabilities and /or expenses is simply fail to record them.

Improper Revenue Recognition

- The most common scheme used in financial statement fraud involves manipulation of revenue figures.

- According to a survey by Deloitte of Accounting and Auditing Enforcement Releases (AAER) filed by the SEC from 2000 through 2008, improper revenue recognition was recognized as the scheme employed in 38 percent of the 403 cases studied.

Improper Revenue Recognition

- Schemes to manipulate revenue figures typically involve posting sales before they are made or prior to payment.

- Examples include recording product shipments to company-owned facilities as sales, re-invoicing past due accounts to improve the age of receivables, pre-billing for future sales and duplicate billings

Improper Revenue Recognition

- An example of manipulating expenses is to capitalize normal operating expenses.
- This scheme is an improper method to delay recognition of the expense and artificially raise income figures.
- An example of this type of scheme is the WorldCom scandal, where significant operating expenses were listed as capital on the balance sheet.

Manipulating expenses

- Concealment and manipulation of liabilities frauds include *failure to record accounts payables* or report regular expenses on financial statements.

- Keeping certain liabilities, leaving notes or loans off-the-books and writing off money lent to executives are also common methods of fraud.

Improper Disclosures

- Accounting principles require that financial statements and notes include all information that a reasonably discerning financial statement user needs to not be misled.
- This includes narrative disclosure notes, supporting schedules and other information required to avoid misleading potential investors, creditors or other users of financial statements.
- If not disclosed in financial statements, disclosure should appear in footnotes or management discussion and analysis.
- Improper disclosures usually involve : Liability omissions, management frauds, related party transaction.

Categories

Liability Omissions

- A pending law suit is an example of a contingent liability.
- The organization's potential liability if material must be discussed.
- Since financial statement users view these disclosures negatively, managers often try to avoid disclosing liabilities.

Overstating Assets

- Overstatement of current assets on financial statements and failure to record depreciation expenses are often employed as methods of fraud.
- Overstatement of inventory and accounts receivables are also commonly used to inflate company assets on fraudulent statements.

Considerations

- Financial statement fraud is expensive and common in private companies.
- According to the Association of Certified Fraud Examiners, the average loss due to financial statement fraud is over $1 million.
- Due to its nature, financial statement fraud is committed by one or more persons in top management.
- Frequently, collusion between a number of persons is found behind such schemes.
- This type of fraud can be devastating to an organization and the morale of the employees who have committed much of their lives to an organization.

Financial analysis Techniques

- The numbers in a set of financial statements do not say much on their own.

- However, when a forensic auditor analyzes the relationship between two line items, or the changes in account balances over time, they might uncover red flags that point them in the direction of possible fraud.

- Financial statement analysis includes the following:
  - Vertical analysis
  - Horizontal analysis
  - Ratio analysis

Vertical and Horizontal Analysis

- Vertical and horizontal analyses are used to identify changes, trends, and significant accounts on the income statement and balance sheet.

- These techniques are a good starting point for a financial investigation because **they quickly highlight which accounts are important and merit further inspection.**

Vertical Analysis

- Vertical analysis is a technique for analyzing the relationships between the items on an income statement, balance sheet, or statement of cash flows by expressing accounts as percentages.

- This allows a financial analyst to quickly determine which accounts are the biggest drivers of company performance.

Example – Vertical Analysis

Statement of Income.

Net Sales	$ 100,000	100%
Cost of goods sold	< 50,000>	50 %
Gross margin	50,000	50 %
Operating expenses	30,000	30 %
Administration expenses	10,000	10 %
Net Income	$ 10,000	10 %

Horizontal Analysis

- This is a technique for analysing the percentage change **in individual financial statement items from one year to the next.**
- The **first year** in the analysis is considered the **base year**.
- The changes to subsequent years are computed as a percentage of the base year.
- This function **determines the trends** of a company's expenses, inventory, etc.
- **Discrepancies in a company's *net profit or a large shift in amount of inventory*** would suggest that something is not right within the company.
- Like vertical analysis, this technique will not work for small, immaterial frauds.

Example- Horizontal Analysis

Income Statement

	Year 1	Year 2	Change %
Net Sales	$ 100,000	$200,000	100%
Cost of goods sold	< 50,000>	< 150,000>	270 %
Gross margin	50,000	50,000	0 %
Operating Expenses	30,000	60,000	100%
Admin. Expenses	10,000	30,000	200 %
Net Income	$10,000	<40,000>	<500>%

Horizontal Analysis

- When conducting a horizontal analysis, the fraud examiner should be aware of certain accounts that almost always move in tandem. Examples include:
  - Sales and cost of goods sold
  - Purchases and freight charges incurred
  - Purchases and payables to cash paid to vendors

Example –Horizontal analysis

Balance Sheet

	Year 1	Year 2	Change
Cash	$ 30,000	$ 5,000	< 83> %
Accts Receivabl e	100,000	200,00	100 %
Investments	20,000	20,000	-0-
Fixed Assets (net)	50,000	45,000	<10> %
Total Assets	$200,000	$270,000	35 %
Accts Payable	$90,000	$200,000	122 %
Long Term Debt	10,000	10,000	-0-
Common Stock	2,000	2,000	-0-
Pd-in-capital	68,000	68,000	-0-
Retained Earnings	30,000	<10,000>	<133> %
Total Liab & Equity	$200,000	$270,000	35 %

Cash Fraud Detection Methods

- Bank Reconciliations – include examining endorsements, dates and all items that appear stale.
- Surprise cash counts – may turn up situations of employees ‘borrowing’. Employees cheques on cash drawer indicates ‘swapping’ cheques for cash.
- Customer complaints – customers who have paid money on an account and have not received credit or a credit they have been given does not agree with the payment they have made.
- Altered or missing documents – If a cash register tape has been altered or missing, further investigation might be warranted

Accounts receivable fraud detection

- Matching Deposit dates – Lapping (robbing Paul to pay Peter) can be detected by comparing the dates of the customer’s payments with the dates the customers accounts are posted.
- Examine the source documents such as the detail of bank deposits .
- Confirmation with the customer –customer cheque details used to pay specific invoices

Inventory Fraud Detection

Statistical sampling

- The auditor /examiner might select a statistically valid, random sample of purchase requisitions to *determine that all requisitions in the sample selected were properly approved.*

- This will enable the auditor/examiner to predict the occurrence rate for the population and therefore determine with some accuracy the potential for fraud.

Raw Materials Requisition

These questions may reveal single source suppliers are being favoured.

- Are raw materials being ordered at the optimal reorder point?
- Are materials ordered from the same supplier?
- Are the established bidding policies being followed?

Detection by Shipping Documents

Theft of inventory may be uncovered by answers such as:

- Are all sales properly recorded with a delivery/shipping note?
- Are any shipping documents not associated with a sale?
- Is inventory disappearing from storage?

Inventory – Analytical Review

- By utilising an analytical review , inventory fraud may be detected.
- Example – If the cost of goods has increased by a disproportionate amount relative to sales, and no changes have occurred in the purchase prices, quantities purchased or quality of products purchased,
- The cost of the disproportionate increase in cost of goods sold may be one of two things:

    1. The ending inventory has been depleted by theft, or

    2. Inventory has been charged with embezzlement(i.e. submitting invoices and collecting payments for inventory that was never delivered.

Inventory- Computer assisted trend analysis

- Amount /frequency of purchases by supplier – If receiving favourable treatment.
- Inventory shipped by address – To find out whether supplier address matches that of employee.
- Disposals then reorders – If usable inventory is being prematurely designated as scrap.
- Returns and allowances – Is there an unusually high incidence of returns

Detecting Purchasing schemes

- Timing of bids – Always the last to bid and the lowest bidder.
- An indication the supplier could be receiving additional favourable information from insiders.
- Amount of work – If bids for a specific type of work are always awarded to a particular company, this may be an indication that employees are favouring that company.

Computer Search – Purchases not subject to Bid

1. Fraud Scheme – **Fictitious vendors**

- *Detection Method* – Vendors and employees with matching addresses.
- More than one vendor with the same address
- Vendors with only post office box addresses.

2. Fraud Scheme – **Over-billing**

   Detection Method – Unusual or 'one time', extra purchasing charges.

3. Fraud scheme **- Conflicts of Interest**

   Detection Method

– Vendors with employees who are family members.

- An unusually high occurrence rate of complaints.

- Higher prices and /or sub standard quality.