Financial Statement Fraud

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Errors, Irregularities, and Fraud

- Error – **unintentional** misstatements or omissions of amounts or disclosures on financial statements
- Fraud is **intentional**

How errors and manipulations arise

Understated liabilities and expenses

Type of financial statement frauds

Overstated assets or revenues

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Financial statement analysis

Use **analytical procedures** for **high volume** transactions

Vertical trend analysis

Horizontal trend analysis

Ratio analysis

*“As **each company** and project is **different**, selection of **analytical procedures** must be appropriate to the circumstances”*

Source: A Guide to Forensic Accounting Investigation

Financial statement analysis (contd.) Vertical and Horizontal analysis

1. **Vertical analysis**
   - Compares elements of the financial statement with a common base item
   - Technique for analyzing the relationships between the items on an income statement, balance sheet, or statement of cash flows by expressing components as percentages.
   - These relationships are compared within each accounting period and then the period under analysis can be compared with historical periods
2. **Horizontal analysis**
   - Used to understand the percentage of change in individual financial statement items over a period of time
   - Technique for analyzing the percentage change in individual financial statement items form one year to the next.

Source: A Guide to Forensic Accounting Investigation

Financial statement analysis (contd.)
Ratio analysis

3. Ratio analysis

- Assesses and measures the relationships
  - among various financial statement items
  - with non financial data
- Can be compared with
  - Historical data
  - Industry data
  - Against a benchmark
- For unexpected changes - source documents and related accounts can be examined in detail

Source: A Guide to Forensic Accounting Investigation

Balance Sheet	Vertical Analysis				Horizontal Analysis	
Assets	Year 1		Year 2		Change	% Change
<u>Current Assets</u>						
Cash	45,000	14%	15,000	4%	(30,000)	-67%
Accounts Receivable	150,000	45%	200,000	47%	50,000	33%
Inventory	75,000	23%	150,000	35%	75,000	100%
Fixed Assets	60,000	18%	60,000	14%	-	-
Total Assets	**330,000**	**100%**	**425,000**	**100%**	**95,000**	**29%**
Accounts Payable	95,000	29%	215,000	51%	120,000	126%
Long-Term Debt	60,000	18%	60,000	14%	-	-
<u>Stock-Holder's Equity</u>						
Common Stock	25,000	8%	25,000	6%	-	
Paid – In – Capital	75,000	23%	75,000	18%	-	
Retained Earnings	75,000	23%	50,000	12%	(25,000)	-33%
Total	**330,000**	**100%**	**425,000**	**100%**	**95,000**	**29%**

Illustration

Financial statement analysis (contd.)

Vertical Analysis v/s Horizontal Analysis - Illustration

Income Statement	Vertical Analysis				Horizontal Analysis	
	Year 1		Year 2		Change	% Change
Net Sales	250,000	100%	450,000	100%	200,000	80%
Cost of Goods sold	125,000	50%	300,000	67%	175,000	140%
Gross Margin	125,000	50%	150,000	33%	25,000	20%
Operating Expenses						
Selling Expenses	50,000	20%	75,000	17%	25,000	50%
Administrative Expenses	60,000	24%	100,000	22%	40,000	67%
Net Income	15,000	6%	(25,000)	-6%	(40,000)	-267%

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Types of financial statement frauds

A.
Misreporting
Misrepresentation

B. Misappropriation of assets

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Types of financial statement frauds

A.
Misreporting
Misrepresentation

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

Types of financial statement frauds

1. Embezzlement
2. Stealing

B. Misappropriation of assets

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Fraudulent financial misreporting

1. Revenue recognition schemes

- Most common type of fraud
- Often use to conceal real numbers of a weak quarter

Excessive number of subsequent period returns of goods, accompanied by an unusual jump in credits

↓

Sales have been recorded before they were actually made

Source: Financial Statement Fraud: Detecting the Red Flags

Fraudulent financial misreporting

2. Fictitious Revenue

- Posting of sales that never occurred

Red Flags

- Unusual increase in assets – mask fictitious revenues
- Missing customer records (e.g., physical address and phone number)
- Unusual changes in ratio patterns (e.g., spike in revenue with no corresponding increase in accounts receivables)

Source: Financial Statement Fraud: Detecting the Red Flags

Fraudulent financial misreporting

3. Concealed liabilities

- Improper or under-reporting of expenses and other liabilities
- Shifting expenses from one entity to another or reclassifying liabilities as assets

Red Flags

- Recurring negative cash flows from operations, while reporting earnings growth
- Invoices and other liabilities go unrecorded in the company's financial records
- Writing off loans to executives or other parties
- Failure to record warranty-related liabilities

Source: Financial Statement Fraud: Detecting the Red Flags

Fraudulent financial misreporting

4. Inadequate disclosure

- Often used after a financial fraud has occurred in an attempt to conceal it

Red Flags

- Disclosure notes are so complex that it is impossible to determine the actual nature of the event or transaction
- Discovery of undisclosed legal contingencies
- Nondisclosure of pending litigations or other contingent liabilities

Source: Financial Statement Fraud: Detecting the Red Flags

Fraudulent financial misreporting

5. Improper asset valuation

- Common form of profit manipulation

Red Flags

- Unusual or unexplained increases in the book value of assets (e.g., inventory, receivables, long term assets)
- Odd patterns in relationships of assets to other components of the financial report (e.g., sudden changes in the ratio of receivables to revenues)
- GAAP violations in recording expenses as assets

Source: Financial Statement Fraud: Detecting the Red Flags

Misappropriation of assets

Misappropriation of assets involves the ***theft*** *of an entity's assets and is often perpetrated by employees in relatively* ***small*** *and* ***immaterial amounts.***

1. Misappropriation of assets can be accomplished in a variety of ways:
   - ***Embezzlement*** of receipts
   - ***Stealing*** physical or intangible assets
   - Causing an entity to pay for goods and services ***not received***, etc.
2. Misappropriation is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing"