

FINANCIAL STATEMENT FRAUD

The ACFE has identified five classification of financial statement fraud. What follows are the classifications, supplemented by some risk factors cited in the SAS 99 Appendix, “Examples of Fraud Risk Factors.”

Fictitious Revenues

- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult ‘substance over form’ questions.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

Examples of items to watch:

- Fictitious or altered invoices.
- Sales with conditions that have not been met.
- Merchandise shipped to warehouses for storage or consignment counted as sales.
- Significant transactions with related parties or special purpose entities (e.g. Enron), or entities whose substance and ownership are not known.

Timing Differences / Premature Revenue Recognition

Examples of items to watch for:

- “Billing and holding” schemes (creating receivable but holding the goods for a later shipping, or not shipping at all; often used with large customers).
- Multi-year projects for which the majority of cash is paid in the first year, but revenue is not spread out over the number of years required for the project (common in the construction business).
- Subscription revenue taken for a multi-year period, obligating the company to multi-year expenses, but all of the revenue is recognized in a one-year period.
- Backdated sales invoices and predated shipments.
- Large journal entries at year end.

Improper Asset Valuations

Examples of items to watch:

- Fictitious records for items that do not exist.
- Unsupported journal entries.
- Inflated inventory count sheets.
- Bogus shipping and receiving reports.
- Fake purchase orders / account receivable.

- Backdated investment documents to report fixed assets at market values.

Concealed Liabilities and Expenses

Examples of items to watch:

- Pending legal, disciplinary or regulatory actions, investigations or inquiries not disclosed by management.
- Capitalizing expenses as assets (e.g. WorldCom).
- Expensing capital expenditures (to minimize tax liabilities).
- Expenses shifted to a later or earlier period.

Improper Disclosures

Examples of items to watch:

- Management failing to disclose significant information such as:
 - Loan covenants
 - Contingent liabilities
 - Court judgments
 - Regulatory decisions
 - Related party transactions
- The use of confusing footnotes (e.g. Enron)
- Footnotes inadequately describing the qualitative nature of investment.

Contact us at ddl@davidsaccounting.com or (630) 986-9074 for a Fraud Protection Check-Up.