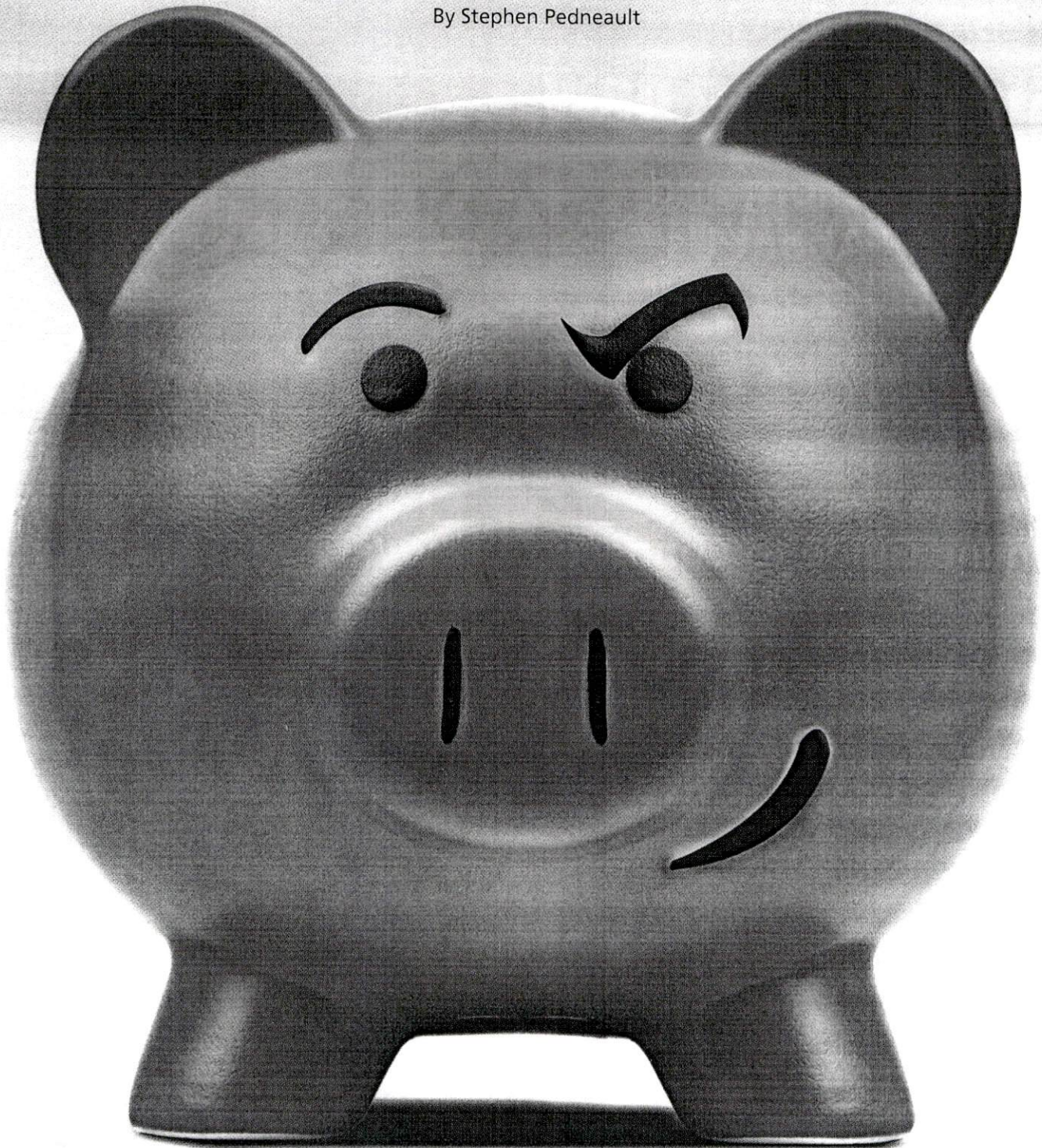


Financial Statement Fraud Schemes

By Stephen Pedneault



The following article is excerpted from *Fraud 101: Techniques and Strategies for Understanding Fraud, Third Edition* by Stephen Pedneault.

Regardless of the size and nature of an organization, the underlying objective behind every financial statement fraud scheme is to intentionally deceive the users of the financial information being provided. It is important not to limit your concept of fraudulent reporting to audited financial statements. The risk for fraudulent reporting also exists with lower level review and compiled financial statements. However, the level of risk and the number of users of these levels of financials tend to be more controlled.

Before we discuss financial statement fraud, we should understand, in general terms, the process of preparing and issuing financial statements. While the level of scrutiny and procedures performed will be highest with audits, the overall process of issuing financial statements in an audit will be similar to those issued within reviews and compilations. Management is responsible for preparing the financial statements, footnote disclosures, and all aspects of the financial reporting. The organization's internal controls and procedures over financial reporting should include measures to ensure the completeness and accuracy of the financial reports prior to making them available to any parties.

Next, the organization's auditors or outside accountants, if a review or compilation is required, are provided with a copy of the drafted financial statements. The auditors then perform detailed procedures to ensure the organization's financial statements are reasonably prepared in accordance with all professional standards and are free of any material misstatements that could cause the financial statements to be misleading. Procedures performed include independent verification of the amounts and details, recalculations, and other objective measures to corroborate management's balances, results, and disclosures. For the auditors to ac-

complish their procedures, they must interact with the organization's management and personnel and rely upon information provided to them by the same individuals. Once all the procedures have been performed, the auditors issue the organization's financial statements, along with their opinion. The final or issued financial statements are then disclosed to any required third-party users, such as investors and financial institutions, the two largest groups of financial statement users.

Where Do Things Go Wrong?

Whether issuing an audited, reviewed, or compiled level of financial statements, much of the information provided to the auditors or accountants originates with management. Procedures are performed in an audit to independently corroborate through third parties the information provided by management, such as confirming details with suppliers and vendors, but no such procedures are required for reviews and compilations. Because management controls the information, they can control how much or little is provided to the auditors. When auditors request supporting details—documents such as sales invoices, purchase orders, and time records—these details are provided by management. Depending on the auditor or accountant's level of training, experience, and skepticism, the documents provided by management may or may not receive much scrutiny.

Herein lays the issue. If the organization's management needs to fool the auditor or accountant into issuing the organization's financial statements with gross inaccuracies or omitting significant details, management controls all the means to make that happen. If, for example, management decided not to disclose certain facts and details, it's likely the auditors would have no other means of

knowing that information had been intentionally withheld. Conversely, if management wanted to show results that were different from those that actually occurred, they could fabricate the supporting documents, and the fictitious information and details provided to the auditors would likely pass their scrutiny.

Turnover in public accounting also contributes to the fraud risk issue, as does the diminishing number of individuals who pursue accounting as a career choice. Recruiting for new accountants has become extremely competitive in recent years, and the decline in new accountants has strained many firms' ability to serve their clients. Many firms have resorted to having new staff members and college interns perform audit procedures, especially inventory observations. Moreover, if senior accountants are spread too thin over multiple engagements, they may never have the time to make trips out to their clients' sites to oversee and guide their young and inexperienced staff.

Many public accounting firms have grown beyond their capacities, and industry continues to lure the most experienced auditors away from public auditing with better hours and higher compensation potentials. It is not the young auditor's fault for missing fraud during an audit—nothing replaces experience. Although most firms have increased training for new and less experienced auditors, the quality of training may not have reached the level needed to truly combat fraud.

Case Study: Engine Light Is On

While working in public accounting, I was responsible for designing audit procedures in response to fraud risks. Based on my experience with the latest developments

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and trends within the forensic department, I would help determine whether the firm was performing the most practical audit procedures possible. In some cases, the procedures were performed across the board for all audits performed by the firm, while others were performed on a client-by-client basis.

In one particular period, I remember the firm had a series of clients who experienced employee embezzlements perpetrated through cash disbursement schemes. In all of the cases, the client had not realized the scheme was occurring until late in the game, when the amounts involved had grown to significant levels. In each instance, the client had grown complacent with the bank reconciliation process, allowing the perpetrators to simply write checks to themselves knowing their fraud would likely never be detected. In response to the frauds, the firm looked to me to decide what additional procedures should be added to audits to ensure a cash disbursement scheme would not go undetected, especially one where the checks were payable to the individual directly.

Since the very first audit I was involved in, right out of college, I had always selected monthly bank statements at random during the period to be reviewed. I would ensure all the cancelled checks listed on the statement had been provided, and I would review the statement as well as flip through the cancelled checks, examining the front and back of each check. It was through this simple procedure that I discovered many issues within clients' accounts.

I strongly suggested the firm adopt my procedure and require every auditor to review a sample of monthly bank statements for what I called "reasonableness." The firm agreed with my assessment, and the review of monthly bank statements on a sample basis throughout the audit period was added to every audit program. However, the firm never properly trained the staff, something that became painfully obvious during the heavy audit season.

I met with many audit teams and asked them how the new procedure was working for their client assignments. Each team told me the same thing—the procedure was very straightforward and took little time to complete. None of the teams had identified anything unusual during their reviews.

Then I asked each team to describe their review process, starting with their understanding of the client's cash disbursement approval and check-signing policies and procedures. I got blank looks, like deer in the headlights. Not one team could answer simple questions, such as how many signatures were required on checks and whether there were dual signature requirements.

The analogy I used to explain the problem to the partners was one involving the check engine light in most cars. You are driving down the street and the check engine light goes on, along with some steam coming from the front of the car. You likely pull over and stop the car, then open the hood to see where the issue could be. Once the hood is open, you stare at the engine as if the problem will be painfully obvious, or better yet, as if the problem could be resolved by simply opening the hood. Given the level of electronics and sophistication of most cars today, aside from identifying that the engine was still in fact in the car, few individuals would have any idea what they were looking at under the hood. Yet we all open the hood and look.

In response, a training session was provided that educated all of the auditors on what information they should obtain and understand in order to form their own expectations regarding the check and disbursement process, prior to reviewing the bank statements and cancelled checks.

Without proper and relevant training and experience, firms will continue to run the risk that their auditors will complete the audit procedures on their engagements without ever truly understanding what it is they are performing and how it relates to the overall financial statements of the client.

Worse still is the declining economy, in which clients are looking for ways to save money and cut costs. Companies are closing their doors, filing bankruptcy, and merging into other entities, all with negative revenue consequences for the public accounting firms' financial situation. In response, auditing firms are placing more and more emphasis on their staff to perform "efficient" audit procedures. Historically, accountants were promoted in large part based on their performance on their engagements, measured most frequently by the profitability to the firm of each client assignment. More pressure exists today to ensure that the engage-

ments remain profitable to the firm.

Given the relatively low experience level of many auditors, the lack of experienced supervision in the field, and the pressure to complete audit procedures within the allotted timeframe per the engagement budget, it is likely that an organization seeking to commit fraud will be able to successfully conceal it from audit detection if the size of the fraud scheme remains under control. Even with better training and a few years of experience, auditors often are no match for the experienced and sophisticated controllers and chief financial officers.

Unfortunately, individuals in the accounting profession are not immune from compromising their professional responsibilities and obligations to protect the public from these schemes. Firms have looked the other way when clients presented false or misleading financial information, either to preserve the client relationship or to receive some form of financial gain (and likely both), undermining their role and the integrity of the entire process. In some instances, auditors or outside accountants have assisted the client in perpetrating financial statement fraud. In others, the organization's accountant has a great relationship with the user of the financial statements, such as a financial institution, where the user may tend to rely on their relationship with the accountant and apply a lower level of scrutiny over the organization's provided financial statements. If the organization's financial performance continues to be successful and the organization provides its financial information in a timely fashion and meets its obligations, the user may never be the wiser. It is only cases in which situations change and the organization experiences a decline or some other event that the past financial statements come into the discussions.

Case Study: How Much Inventory Is Too Much?

The bank was getting nervous. One of their manufacturing customers, which had been a great customer of the bank for the past several years, was falling farther and farther behind in its debt repayments. The last set of financial statements provided was of the review level and were issued by a local certified public accounting firm. While the bank was nervous about their \$4.5 million line of credit and term debt outstanding, they were

somewhat appeased that the company reported their inventory at \$10 million as of December, just three short months ago. The balance sheet even appropriately included a reserve for obsolete and slow-moving inventory of \$20,000.

On the first visit to the customer's facility, however, it was obvious there was more inventory on hand than they would ever need for their business. Machines were running, producing yet even more inventory, and walking room within the three warehouses was constricted to single-file aisles. Product was stored as high as the ceilings, and more was being produced, with three shifts in operation.

Management's explanation for the overage of inventory was that there were three primary customers for their products, and each required their own unique packaging. They also stated that each customer demanded that its products be ready to ship at a moment's notice, but would not take title to any product until an order was placed and the items physically left the warehouses. The result was an excess inventory of identical products, stockpiled in three different areas depending on the customer and its packaging. To make the situation even worse, management indicated that product sales were decreasing because recently, similar products had begun being imported from the Middle East, selling at a fraction of the company's cost to make the same items.

Upon review of the financial statements issued three months earlier, the bank's auditors revisited the reserve amount reported for slow-moving and obsolete inventory. Next, they extracted all the product items from the customer's inventory system, including the last purchase date and last sale date for each item. Focusing only on items that had no purchases or sales activity in the last 24 months, the auditors extracted the current inventory levels and costs associated with any items that had no activity in the past 24 months.

The results were staggering. Notwithstanding the unknown financial impact of the increased competition from foreign competing items, the bank's auditors determined, based on the company's past sales trends, that the true reserve for slow-moving and excess inventory was between \$3 and \$4 million. Worse yet, the customer was still

actively producing more products every hour of every day.

The bank auditors turned their attention to the outside accounting firm and the review that firm had performed. Although an audit had not been performed, meaning that a lower level of scrutiny and procedures had been provided, the bank auditors questioned how the outside accounting firm's reserve calculation of \$20,000 just three months earlier could be so far off from the bank auditor's calculated range of \$3 or \$4 million? It became obvious the customer's balance sheet was grossly overstated and that the bank could easily suffer a loss, as the inventory, if liquidated by the bank to cover their outstanding debts, would only yield a fraction of the costs the customer had incurred to make it.

How could this happen? Quite simply, the reserve calculations and supporting details provided by management were less than complete. Either the accountants did not ask for the right information, they were not provided the best evidence available to make their own determination of the reserve amount, or they fell into the trap of relying too heavily on the client's information, representations, and calculations. In the case study of the bank's manufacturing customer, the owner simply told the accountants that the information they requested to perform an independent calculation of the reserve could not be provided, due to the age and other limitations of the inventory system used. The accountants never pursued the issue, and unfortunately for them management's story proved not to be the case. When pushed by the auditors, the owner was able to generate the inventory report and export it into Excel for analysis. To determine the activity for identified items within the previous 24 months, the auditors sat in front of computer terminals and manually researched the information on the screens.

The December 2008 report issued by Deloitte's Forensic Center, entitled *Ten Things about Financial Statement Fraud—Second Edition*, identified the financial statement fraud schemes most commonly committed by publicly traded companies, along with frequency of occurrence. Here are the most commonly reported schemes, along with their reported frequencies:¹

- Improper revenue recognition 38%

- Improper disclosures 11%
- Manipulation of expenses 11%
- Manipulation of liabilities 8%
- Manipulation of assets 8%
- Manipulation of reserves 7%
- Manipulation of accounts receivable 4%

Trend Analysis

Trend analysis is one of the most common means of detecting fraudulent issues within financial statements. Comparing balances and results on the most recent balance sheet, income statement, and statement of cash flows to the same information for prior periods is a common auditing procedure. The ending balances of one year are usually compared to balances for the same period a year ago, such as when current month- and year-to-date amounts are compared to prior year amounts. However, if account balances and results are manipulated each year, these trend analyses may never reveal a potential fraud scheme.

If the trending is expanded to include a comparison of the major account balances for each month in the fiscal year, along with the subsequent months since year end, the analysis may show unexpected results and balances in the months ending each quarter or in the last month of the year, followed by decreased activity in the month immediately following the period end. This may be a sign that the results were manipulated to meet period goals or objectives and were reversed in the subsequent month. The month-to-month trending, especially if performed for the current and past fiscal years, will show if any patterns exist to be further analyzed.

Comparing amounts on the balance sheet or income statement across periods is known as a *horizontal trend analysis*. While many individuals who are contemplating or committing fraud know that auditors will compare annual or quarterly amounts and results, few expect the auditors to use monthly amounts in their trending. Monthly trend analysis of the balance sheet and income statement for a two-year period was standard on all my financial statement engagements.

Another important trend analysis to be performed, especially for the income statement, is a *vertical trend analysis*, in which all the

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major expense items are shown as a percentage of sales. Once again, the current period's vertical analysis should be compared to prior period percentages, and any significant changes should be investigated and corroborated.

An example of vertical trend analysis commonly calculated is cost of sales and gross margin. Both are shown as a percentage of sales. However, a client who is contemplating committing financial statement fraud, otherwise known as "cooking the books," likely knows the line items and percentages that will be analyzed by their auditors. Therefore, the balances and percentages will be intentionally held to consistent levels from prior periods to avoid additional scrutiny, and the remaining fraudulent transactions will be concealed to other accounts within the income statement and balance sheet. Applying vertical trend analysis to the entire income statement and selected balance sheet accounts may reveal this concealment scheme.

A third trend analysis is to compare related accounts and balances to ensure relationships between the accounts are reasonable. For example, there should be a direct relationship between purchases, sales, and inventory. If sales have increased during the fiscal year and purchases have remained flat compared to the prior year, then inventory should have decreased, as the increased sales had to get the additional items sold from somewhere. The relationships will either be present or not. Auditors need to identify the different accounts that have direct relationships and ensure that, based on the actual results reported, each related account balance reflected the auditor's expected results.

Many organizations and companies have sophisticated accounting and finance departments, commonly staffed by individuals experienced in auditing. Based on past audit experience, the client's accounting staff is often very aware of the audit procedures to be performed and the financial areas the auditors will target. They are also aware of the dollar thresholds auditors often set, known as materiality, to determine what balances and transactions will be analyzed. To combat the risk that a client could fool the auditors, the accounting profession's pronouncements strongly suggest that auditors perform more unannounced procedures and

add procedures not expected of the client to add an element of unpredictability to the audit process.

Regardless of the level of financial statement being provided to a client and any past relationships with the owners and management, auditors must remain independent, objective, and skeptical, approaching each engagement as if it was their first experience with a brand-new client. Anything less will likely cause the auditors or accountants to miss the fraud.

Beyond Traditional Audits

Financial statements and information are often generated and provided by organizations for reasons beyond annual audits. For example, companies involved in a lawsuit may be required to provide financial information to support or negate a claim. An organization that experiences a loss of any kind may be required to provide a damage calculation along with all supporting financial information.

In most cases, traditional audit procedures are not performed outside an audit, although there often are no limitations preventing the performing of the audit steps. Often, the level of sophistication in a financial fraud scheme is much lower than when committed during a traditional audit. Performing the trend analysis procedures described above on the financial information provided will often identify issues and help determine whether reliance should be placed on the information. Corroborating the financial information between one source and another could also identify reliability issues, such as reconciling results and amounts between the financial reports and the entity's tax returns.

Case Study: Asset-Based Lending (ABL) Fraud

A company has limited means to borrow funds. A mortgage exists on the building, and there are outstanding loans on the equipment and vehicles. Yet the company requires more cash flow to fund operations. Many banks have asset-based lending programs available, whereby the company can borrow against their eligible accounts receivables and inventory. The bank defines what constitutes eligibility, and the company can borrow amounts up to a set borrowing limit, based on accounts receivables and inventory on hand.

To ensure the accounts receivable and inventory amounts are valid, banks often use internal auditors as well as external auditors to visit the customer's location and independently verify the existence of the receivables and inventory. Procedures that are similar, if not identical, to traditional audit procedures are performed in these areas, and the bank receives assurance that the customer's collateral is valid and creditworthy. The process is often termed a collateral review.

I was assigned, along with a colleague, to complete a collateral review of a local manufacturer. Before contacting the customer, we requested and received the monthly financial information provided to the bank by the customer for the past year or more. The monthly borrowing base certificates, the form used by the customer to certify that the amounts reported were complete and accurate, were provided, as were the periodic inventory and accounts receivable reports. We also received a copy of the company's latest corporate tax return.

We determined the customer's borrowing eligibility was limited to outstanding customer balances (receivables) less than 60 days outstanding, along with raw material inventory purchased in the last 12 months. The company did not have any significant work in process or finished goods inventory. The maximum borrowing the company could obtain through ABL was \$1.5 million. The first issue we identified related to the customer's tax return. Although the bank lent the customer funds based on their inventory on hand, the company reported no inventory on their tax returns.

We contacted the customer and scheduled a visit to perform the procedures. We asked them to have their monthly internal financial reports available, including detailed monthly inventory and accounts receivable reports. When we arrived at the company, we asked for a tour of the facility. As we walked throughout the plant, we noticed raw material inventory throughout the shop. We asked the customer about the materials, their approximate values, and how they were used in their processes.

Next, we began reviewing the monthly accounts receivable aging reports. Using the totals for each month, we entered the amounts into a spreadsheet, tracking the aging buckets (current, 30 days, 60 days .

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. . .) for each month. After entering the first few months, we noticed that the customer's balances never seemed to get older than 60 days. Using the horizontal trend analysis, we created line graphs of the receivable buckets across the entire period. We wondered how this company could contain every customer receivable to below 60 days.

Without raising suspicions, we completed our two-year analysis. We asked the customer for monthly detailed general ledger reports, which they provided electronically in PDF files. As we scanned through the monthly transactions within the sales and accounts receivable accounts, we noticed a significant level of sales credits posted each month, followed by additional sales transactions. The amounts and details of the sales credits and subsequent invoices were similar.

The customer had developed a routine to ensure the maximum borrowing could be obtained each month by manipulating the accounts receivable to maintain every unpaid account balance under the 60-day limit. As any unpaid balance approached the 60-day limit, the original sale was credited (reversed) and then re-recorded using a more

recent date, allowing the receivable balance to remain "eligible" for another two months, until collected (or reversed and re-recorded again).

Once the scheme was identified, all of the outstanding balances were traced back to the original sales dates and aged appropriately within a spreadsheet. The end result was the bank had overextended credit by nearly half the outstanding balance. We found that most of the account balances exceeded the "eligibility" (60-day) period and should not have been included in the borrowing base calculation.

Regarding inventory, the customer was expensing its inventory for tax purposes while carrying the inventory on the books for borrowing purposes. The customer was committing an obvious tax fraud scheme to minimize income and therefore minimize taxes. We identified this to the bank, and indicated there was a significant potential tax liability in the event the federal or state revenue services identified the customer's tax reporting scheme.

The bank began to work out arrangements, and the customer ultimately refinanced the outstanding loan with another financial in-

stitution. The bank received its funds, and now the customer is another bank's problem. The point of caution here is that financial statement fraud is not limited to audited financial statements. Any financial information, regardless of whether it is audited, reviewed, compiled, or simply produced by a client, is susceptible to fraud and manipulation. Regardless of why financial information is provided, measures need to be implemented and procedures need to be performed to ensure the information is reasonably complete, accurate, and reliable. **CL**

Stephen Pedneault, CPA, CFE, CFF, FCPA, is the principal and founder of Forensic Accounting Services LLC, a CPA firm specializing in forensic accounting, employee fraud, and litigation support matters. Reprinted with permission of John Wiley & Sons, Inc. Stephen Pedneault, Fraud 101: Techniques and Strategies for Understanding Fraud, 3E, 2009

Notes

1. *Ten Things about Financial Statement Fraud, Second Edition*. A review of SEC enforcement releases (Deloitte Forensic Center: December 2008).