

Financial Statement Fraud: Motives, Methods, Cases and Detection

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Abstract

Financial reporting frauds and earnings manipulation have attracted high profile attention recently. There have been several cases by businesses of what appears to be financial statement fraud, which have been undetected by the auditors.

In this Project, the main purpose is to focus on the nature of financial statement fraud, and fraud schemes regarding to financial statements. The Project also discusses common techniques used to detect financial statement frauds. Two cases of the fraudulent financial statements of Enron and WorldCom are analysed.

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1. Introduction

1.1 Background

Financial reporting frauds and earnings manipulation have attracted high profile attention recently (Intal and Do 2002, 1). Over the past two decades, incidents of financial statement fraud have increased substantially (Rezaee 2002, 18).

According to Wells (2005, 325-327), financial statement fraud is harmful in many ways. It:

- 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, e.g. Andersen
- Diminishes the confidence of the capital markets, as well as market participants, in the reliability of financial information
- Makes the capital markets less efficient
- Adversely affects the nation's economic growth and prosperity
- Results in huge litigation costs
- Destroy careers of individuals involved in financial statement fraud
- Causes bankruptcy or substantial economic losses by the company engaged in financial statement fraud
- Encourages regulatory intervention
- Causes devastation in the normal operations and performance of alleged companies
- Raises serious doubt the efficacy of financial statement audits
- Erodes public confidence and trust in the accounting and auditing profession

For example, financial statement fraud committed by Enron Corporation is estimated to have caused a loss of about \$80 billion in market capitalization to investors, including sophisticated financial institutions, and employees who held the company's stock in their retirement accounts (Forbes 2007).

Furthermore, "public statistics on the possible cost of financial statement fraud are only educated estimates, primarily because it is impossible to determine actual total costs since not all fraud is detected, not all detected fraud is reported, and not all reported fraud is legally pursued" (Rezaee 2002, 8). Therefore, financial statement frauds together with audit failures have been increasingly a hot issue.

As a result, more people believe professional accountants have to learn how to detect financial statement fraud more effectively. One of the best ways is to profit from the mistakes of others. The consequences of individual cases (Enron, WorldCom ...) above can offer the profession an opportunity to learn and grow.

1.2 Research Issue and Purpose

In this Project, the main issue and purpose is to understand the real nature of financial statement fraud (what it is; who, why and how to commit; a framework to detect and prevent). In order to achieve this target, two cases (Enron and WorldCom) are chosen to illustrate and analysis. Since two companies to study in this Project applied US Generally Accepted Accounting Principles (GAAP), the analysis is conducted in accordance with the US GAAP and appropriate regulations and laws.

1.3 Scope and Limitations

There are different types of financial statement fraud taking place in organizations, briefly, according to (Kwok 2005) they can be categorized as follows:

- Selling more
- Costing Less
- Owning more
- Owing Less
- Inappropriate Disclosure
- Other Miscellaneous Techniques

Studying all of the above mentioned fraud categories since the topic is too broad and the duration time of the Project writing does not allow to cover all of the techniques in depth. The Project is researched theoretically because it is based on library research without having the collection of data and other practical techniques (interviewing companies, questionnaires and so on).

2. Overview of Financial Statement Fraud

2.1 Definitions of Fraud and Error

2.1.1 Fraud

According to (Singleton et al. 2006), fraud is a word that has many definitions:

Fraud as a crime. “Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery” (Singleton et al. 2006, 1-2)

Fraud as a tort. The U.S. Supreme Court in 1887 provided a definition of fraud in the civil sense as (Bologna and Lindquist 1995, 9)

First: That the defendant has made a representation in regard to a material fact;

Second: That such representation is false;

Third: That such representation was not actually believed by the defendant, on reasonable grounds, to be true;

Fourth: That it was made with intent that it should be acted on;

Fifth: That it was acted on by complainant to his damage; and

Sixth: That in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true.

2.1.2 Error

Error is a mistake which is unintentional (Albrecht and Albrecht 2003, 6). Therefore, fraud is different from unintentional errors.

2.2 Types of fraud

According to (Albrecht and Albrecht 2003, 8), fraud can be classified into five types (Table below). Fraud that does not fall into one of the five types and may have been committed for reasons other than financial gain is simply labelled miscellaneous fraud.

Types of Fraud	Victim	Perpetrator	Explanation
1. Employee embezzlement or occupational fraud	Employers	Employees	Employees directly or indirectly steal from their employers.
2. Management fraud	Stockholders, lenders, and others who rely on financial statements	Top management	Top management provides misrepresentation, usually in financial information
3. Investment scams	Investors	Individuals	Individuals trick investors into putting money into fraudulent investments.
4. Vendor fraud	Organization that buy goods or services	Organizations or individuals that sell goods or services	Organization overcharge for goods or services or no shipment of goods, even though payment is made
5. Customer fraud	Organizations that sell goods or services	Customers	Customers deceive sellers into giving customers something they should not have or charging them less than they should

As stated in the table above, financial statement fraud is the deliberate fraud committed by management that injures investors and creditors with materially misleading financial statements (Kerwin 1995, 36)

2.3 Definitions of Financial Statement Error and Fraud

Mis-statement or accounting irregularities in financial statements can arise from error or fraud (Kwok 2005, 21). Therefore, it is helpful to distinguish between financial statement error and financial statement fraud.

Financial statement error definition

“Error refers to an unintentional mis-statement in financial statements, including the omission of an amount or a disclosure, such as:

- A mistake in gathering or processing data from which financial statements are prepared;
- An incorrect accounting estimate arising from oversight or misinterpretation of facts; and
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure” (Kwok 2005, 21)

Financial statement fraud definitions

Financial statement fraud has been defined differently by academicians and practitioners.

Elliott and Willingham (1980, 4) view financial statement fraud as management fraud:

“The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.”

Besides investors and creditors, auditors are one of the victims of financial statement fraud.

They might suffer financial loss (e.g. loss of position, fines, etc.) and/or reputation loss (Rezaee, 2002).

Gravitt (2006, 7) say that financial statement fraud may involve the following schemes:

- Falsification, alteration, or manipulation of material financial record, supporting documents, or business transactions
- Material intentional omissions or misrepresentations of events, transactions, accounts, or other significant information from which financial statements 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

Financial statement fraud is the most common fraud committed on behalf of an organization – through actions of the top management. Accordingly, the terms management fraud and financial statement fraud are often used interchangeably.

2.4 Types of financial statement fraud

According to AICPA¹ (2002), two types of intentional mis-statements are relevant to an audit of financial statements and auditors' consideration of fraud.

The first type is misstatements arising from fraudulent financial reporting, which are defined as “intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users”

The second type is misstatements arising from misappropriation of assets. Misappropriation of assets involves the theft of an organization's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an organization to pay for goods and services not received). Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing, **indirectly** causing accounting irregularities in financial statements (Kwok 2005, 22)

The primary focus of this Project is on the first type: misstatements arising from fraudulent reporting that **directly** cause financial reports to be misleading and deceptive to investors and creditors.

¹ American Institute of Certified Public Accountants

2.5 Who commit financial statement fraud?

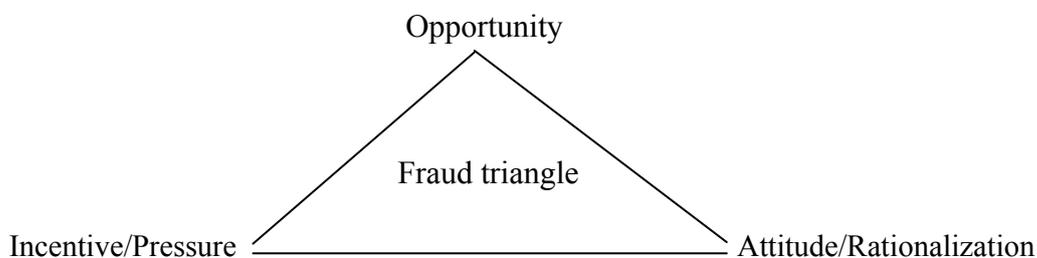
Financial statement fraud can be perpetrated by anyone at any level, who has the opportunity. There are two main groups (Taylor 2004). In descending order of likelihood of involvement, they are:

- Senior management (CEO, CFO, etc.). CEO was involved in 72 percent of the frauds while the CFO was involved in 43 percent. Either the CEO or the CFO was involved in 83 percent of the cases (Wells 2005, 288)
- Mid- and lower-level employees. These employees are responsible for subsidiaries, divisions, or other units and they can commit financial statement fraud to conceal their poor performance or to earn bonuses based on the higher performance (Wells 2005, 288)

2.6 Why do people commit financial statement fraud?

Generally, it is noted that fraud like other crime, can best be explained by three factors: a supply of motivated offenders, the availability of suitable targets and the absence of capable guardians – control systems or someone to mind the store (Sheetz and Silverstone 2007, 18)

Therefore, fraud typically includes three characteristics, which are known as the “fraud triangle” (Turner, Mock and Srivastava 2003, i)



Incentive/Pressure: Pressures or incentives on management to materially misstate the financial statements.

There are many pressures. When financial statement fraud occurs, companies overstate assets on the balance sheet and net income on the income statement. They usually feel pressured to do so because of a poor cash position; receivable that are not collectible; a loss of customers; obsolete inventory; a declining market; restrictive loan covenants that the company is violating; unrealistic revenue and profit expectations; meet analyst's expectations; pending bankruptcy or delisting (Harfenist 2005).

Opportunity: Circumstances that provide an opportunity to carry out material misstatement in the financial statements. The following opportunities may lead financial statement fraud (Taylor 2004)

- Absence or improper oversights by board of directors or audit committee
- Weak or nonexistent internal controls
- Financial estimates requiring significant judgments
- Complex accounting rules (who is to blame?)
- Complex organization structure
- Highly complex transactions
- Significant related party transactions

For example, Enron had complex structure: over 2000 subsidiaries (3500 affiliates); at 23 states and 62 countries. Enron also used complex accounting (special purpose entities).

Attitude/Rationalization: An attitude, character or set of ethical values that allows one or more individuals to knowingly and intentionally commit a dishonest act, or a situation in which individuals are able to rationalize committing a dishonest act (Harfenist 2005). For instance, management can think of committing financial statement frauds like:

- Competitors are doing it

- The activity is not criminal
- Ensuring companies' goals are being met
- It is just a timing issue
- We are protecting shareholder value (by manipulating financial reports to maintain or increase share prices).

3. Financial statement fraud schemes (how do people commit financial statement fraud?)

3.1 Double-entry book-keeping

The fundamental idea of double-entry book-keeping is that all monetary transactions will be recorded twice as debit and credit in the accounts based on the principle that every monetary transaction involves the simultaneous receiving and giving of value (Hoggett, Edwards and Medlin 2005).

Uncovering accounting irregularities often requires an understanding of the debits and credits. Total debits must be equal total credits. If it is not, there must be errors (omission and so on) in recording transactions or accounting irregularities because one side of the accounting entries is missing (Hoggett, Edwards and Medlin 2005).

However, a balanced set of accounts does not guarantee the financial statements are free from misstatements or accounting irregularities. For instance, a \$10,000 cash shortfall, it is plausible to suspect that the perpetrator may have attempted to conceal the theft (the credit in the cash book) by labelling the stolen \$10,000 as a legal expense (the debit in the legal expense account).

A good understanding of the audit trail through various steps of the accounting cycle is important in investigating accounting irregularities. They start with a source document such as an invoice, a cheque, a receipt or a received report. These source documents become the basis for accounting entries which effectively the chronological listings of the debits and credits entries of transactions. Entries are made in various journals which are posted to the appropriate general ledger account. The summarized account amounts become the basis for financial statements for a particular year

3.2 Accounting equation and financial statements

According to Hoggett, Edwards and Medlin (2005), it is stated as follows:

The balance sheet is effectively an extension of the accounting equation by listing assets, liabilities and capital. The balance sheet shows total assets, liabilities and owners' equity at a specific point in time (the last day of a financial year).

$$\longrightarrow \text{Assets} = \text{Liabilities} + \text{Capital (owners' equity)}$$

The profit and loss statement (income statement) show how much profit (or loss) an organization has made during a financial year. On the income statement, two types of accounts reported are revenues and expenses with the format as follows:

$$\longrightarrow \text{Profits} = \text{Revenues} - \text{Expenses}$$

The capital in an organization usually can be viewed as from two sources: retained profits and owners' contributions (share capital). At the end of each financial year, revenues and expenses on the income statement are closed and brought to a zero balance and the difference, net profits (losses) are added to (or deducted from) retained profits on the balance sheet

$$\longrightarrow \text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Retained Profits}$$

(where Retained Profits = Profits – Dividends)

Therefore, the income statement ties to the balance sheet through the retained profits

3.3 Fraud schemes

Revenue and Expenditure are in the profit and loss statement (income statement). Assets and Liabilities are in the balance sheet. Moreover, Revenues (sales); Expenditures; Assets; Liabilities are main categories of financial statements. Discussions of fraud schemes in this Project are implemented following these categories.

3.3.1 Selling more (overstatement of sales revenue)

Sales (revenue) are usually the largest item in a Profit and Loss statement of most organizations. Sales figures have a direct impact on the profit. They provide a good indication of the activity level and capacity of the organization in question. Furthermore, appearing on the first row in the Profit and Loss statement, the sales figures tends to attract a significant level of attention from the readers of financial statements (Penman 2007).

Consequently, in recently years, investors in certain industries and start-up organization usually focus on sales growth and acceleration as a reflection of an organization's potential (Wild, Subramanyam and Halsey 2007)

Therefore, financial statement fraud involving overstatement of sales have the purpose of portraying a selling – more illusion and inflating the organization's profitability.

According to Wells (2005, 328), sales (revenue) generally are realized or realizable and earned when all of the following criteria are met:

- Sales are gross inflows of economic benefits from buyers to sellers
- Sales are transfers of the significant risks and reward of goods or service from sellers to buyers
- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- The seller's price to the buyer is fixed or determinable
- Sales are final and unconditional, and sellers have no more influence and/or control over the goods or service
- Sales are quantifiable, the amount can be measured reliably
- Collect ability is reasonably assured

Based on criteria above, accounting irregularities of sales are examined below

3.3.1.1 Sales (revenue) in improper periods

This scheme classifying a transaction as a sale before it is consummated or recording revenues too soon (Zacharias 2001)

a) Bill and Hold Sales Transactions

“Bill and hold” is the term used to describe when a selling company holds merchandise to accommodate a customer (Pesaru, 2002). In a bill and hold deal, the customer agrees to buy goods by signing the contract, but the seller retains possession until the customer requests shipment. An abuse of this practice occurs when a company (the seller) recognizes the early revenue of bill and hold sales transactions (Young 2002, 109).

In the bill and hold deal, the transactions meet two conditions of (1) realized or realizable; and (2) earned. However, commonly the revenue is recognized only when the goods and services are delivered to the customers. Therefore, it is necessary to understand the substance of the transactions to make sure that they are legitimate and arm's-length transactions (Rezaee, 2002).

b) Channel stuffing (trade loading)

Suppliers sometimes boost sales by inducing distributors to buy substantially more inventory than they can promptly resell. Inducements to overbuy may range from deep discounts on the inventory to threats of losing the distributorship if the inventory is not purchased (O'gara 2004, 103).

Distributors and resellers sometimes delay placing orders until the end of a quarter in an effort to negotiate a better price on purchases from suppliers that they know want to report good sales performance. This practice may result in a normal pattern of increased sales volume at the end of a reporting period. An unusual volume of sales to distributors or resellers, particularly at or near the end of the reporting period, may indicate channel stuffing (Intal and Do 2002).

“The downside of channel stuffing is that by stealing from the next period's sales, it make it harder to achieve goals in the next period, sometimes leading to increasingly disruptive levels of channel stuffing and ultimately a restatement” (Wells 2005, 333).

c) Improper cut-offs of sales

Perpetrators may also leave the books and accounts open for an excessively long time after the financial year-end in order to record sales that are taking place after the year-end (record sales of the subsequent reporting period in the current period) (Best et al. 2005, 509-510).

d) Shipping goods before a sale is finalized

In some situations, at the time of being close to the fiscal year-end, if the profits targets are lagging, the management can commit financial statement fraud by shipping goods and booking sales, even if the customers did not yet order the merchandise (Kerwin 1995).

e) Recording sales (revenue) when uncertainties exist

The seller still bears the risk of ownership (the risk of ownership has not been transferred) and therefore a sale has not occurred.

There are cases where the seller makes some sales but concurrently agrees to repurchase the same goods at a later date. In essence, the seller exercises a call option to repurchase, or the buyer exercises a put option to resell to the seller of the same goods. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to sales revenue (Sauer 2002)

f) Side Agreements

Management can use side agreements to alter the terms and conditions of recorded sales transactions to aim at enticing customers to accept the delivery of goods and services.