Financial Statement Fraud

Improper Revenue Recognition

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Revenue Overstatements

ANALYST QUOTE:

"The top line is the bottom line for investors today."

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Premature Revenue Recognition

- Holding the books open beyond the end of the reporting period to record large or unusual transactions before or after the end of reporting periods
- Shipping products before a sale is consummated or indications that customers are not obligated to pay for shipments

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Premature Revenue Recognition (cont.)

- Recording bill-and-hold sales transactions or other indications that sales are recognized in advance of shipment
- Recognizing conditional sales depending on the availability of financing, resale to third parties, final acceptance, performance guarantees, and further customer modifications

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Premature Revenue Recognition (cont.)

- Overstating percentage-of-completion revenues when there are uncertainties about the bona fides of the underlying contract
- Improperly recording sales returns and allowances

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Premature Revenue Recognition (cont.)

- Recording sales of products shipped in advance of the scheduled shipment date without the customer's agreement
- Recognizing partially completed goods in the process of being assembled and shipped to customers as actual sales

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Premature Revenue Recognition (cont.)

The *Revenue Recognition in Financial Statement* guidance from the SEC indicates that revenue generally is realized or realizable and earned when all of the following criteria are met:

- 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.
- Collectability is reasonably assured.

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SEC Factors—Common Sense

"We accountants need to look at ourselves and how <u>we have participated in or been the architects of management fraud</u>. I do not criticize the SEC for promulgating the obvious. However, it is <u>regrettable</u> that we accountants have created or participated in the situation where the <u>SEC feels compelled to promulgate the obvious</u>."

--Accounting Educator

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COMPANY EXAMPLES

- **XEROX—Equipment revenue timing—$3 billion**
- **SUNBEAM—Bill and hold and "channel stuffing"**
- **CUC INTERNATIONAL—Phony entries—long-term scheme**
- **OTHER—Manufactured home retailer**

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XEROX'S ACCOUNTING "TERMS OF ART"

- "Accounting actions"
- "Accounting opportunities"
- "Topside adjustments"
- "One-time actions"
- "Accounting tricks"
- "Closing the gap"
- "Margin normalization"

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XEROX Creativity on Sale-Type Leases (ROE Scheme) for Revenue Recognition

Total Lease Payments

Less: Allocated financing income

(Unrealistically low rates)

Less: Maintenance contract revenue

(unrealistically low allocation)

Equals: Allocation to the "box" (the box is the actual piece of equipment)

The "box" revenue is recognized immediately

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XEROX Creativity on Sale-Type Leases (Margin Normalization Scheme)

- **Top-side adjustments done near end of accounting periods**
- **Consolidated level reallocations of service revenue to the "Box" based on an assumed gross margin differential**
- **Done so that reported international business profit margins were similar to those in the U.S.**

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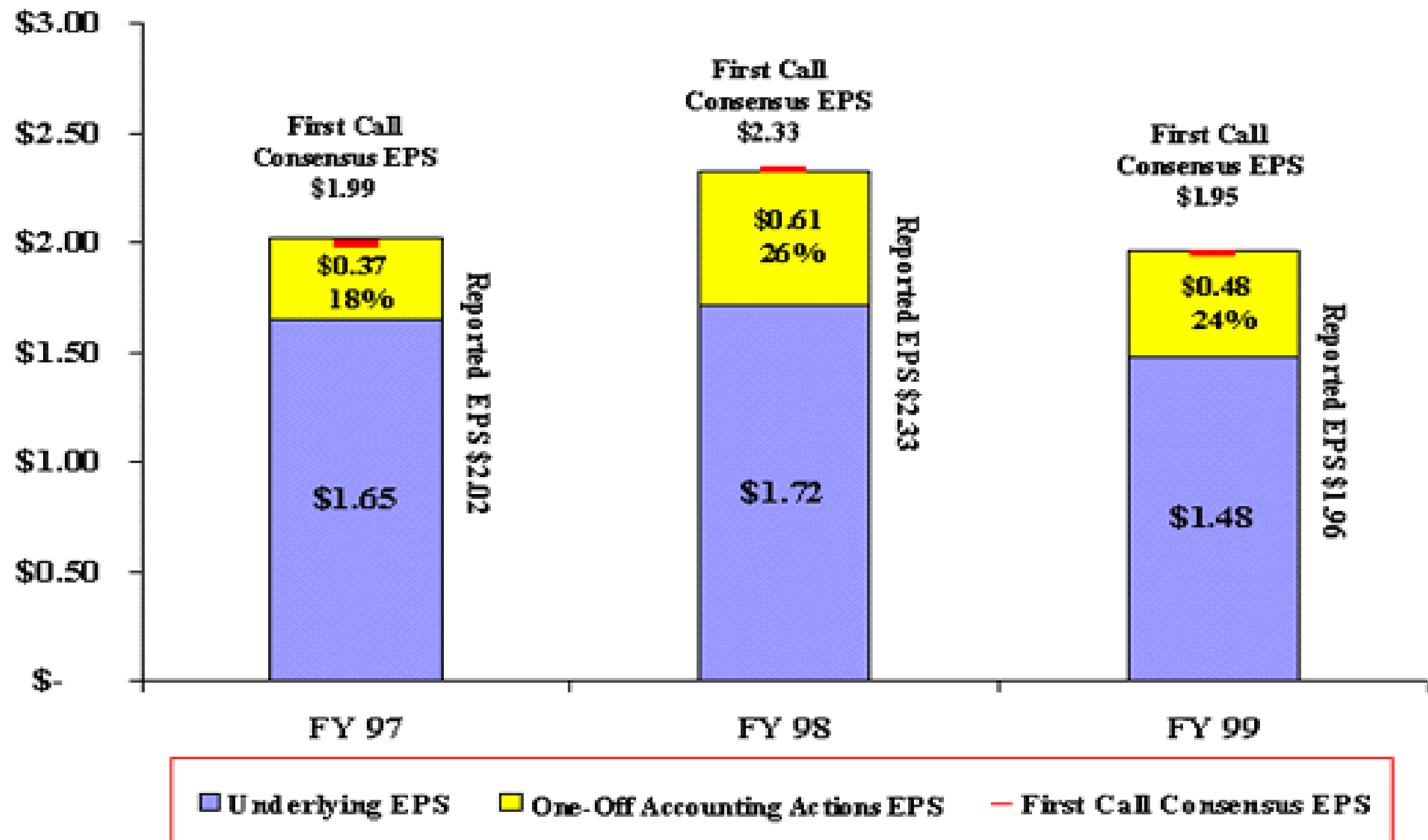

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XEROX—MEET or BEAT!

	FY 1997	FY 1998	FY 1999
UNDERLYING EPS	$ 1.65	$ 1.72	$ 1.48
ONE-OFF ACCOUNTING ACTIONS EPS	2.02	2.33	1.96
FIRST-CALL CONSENSUS EPS	1.99	2.33	1.95

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XEROX'S Auditors' Comments

Safran told Conway (both auditors) that he was concerned specifically about the LAST MINUTE changes to the [accounting methodologies used] and more generally about Xerox's tendency to apply CHANGES IN ESTIMATES FREQUENTLY and at the END of reporting periods.

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Analyst's comment on XEROX revenue correction for 2000 and 2001?

- **After the correction, ". . . it shows XEROX having more revenue in 2001 than we previously expected. The company is actually more solid than people thought it was a day ago."**

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Other Methods

- Long-term contracts
- Channel stuffing
- Recording financing arrangements as sales
- Misclassifying gains
- Less-than-arm's-length transactions
- Bill-and-hold schemes

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Fictitious Revenues

Fictitious revenues are the second most popular method of cooking the books. It involves the recording of goods or services that did not occur.

Companies must make fictitious entries to record fictitious sales.

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A fictional entry is made to record a purported purchase of fixed assets. This entry debits fixed assets for the amount of the alleged purchase and the credit is to cash for the payment:

Date	Description	Ref.	Debit	Credit
12/01/08	Fixed Assets	104	350,000	
	Cash	101		350,000

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A fictitious sales entry is then recorded for an amount equal to the false fixed asset purchase, debiting accounts receivable and crediting the sales account.

Date	Description	Ref.	Debit	Credit
12/01/08	Accounts Rec	120	350,000	
	Sales	400		350,000
12/15/08	Cash	101	350,000	
	Accounts Rec	120		350,000

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Recording Sales That Lack Economic Substance

- Under this scheme, the company sells a product to a customer, yet the customer has no obligation to keep the product or pay for it. A side agreement hidden from the auditors modifies the sales contract.

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Recording Cash Received in Lending Transactions as Revenue

- Money borrowed from banks and others is considered a liability of the company. There have been instances when fraudsters have reported the cash received in lending transactions as revenues.

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Recording Non-Revenue Sources of Cash as Revenue

- Non-revenue sources of cash flow may include asset sales and other investment income. Since these items did not result from selling a product or serving a customer, it would be inappropriate to record them as sales revenue.

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Recording as Revenue Supplier Rebates

- Occasionally, a company will agree to overpay for inventory today, provided the vendor rebates that excess charge with a cash payment in later periods. Further, rebates are often given by vendors based on purchase volumes. Recording rebates as revenue is improper. Instead, rebates represent an adjustment to the cost of the inventory purchased.

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Releasing Revenue That Was Improperly Held Back Before a Merger

- Inflating revenue right after the closing of an acquisition is a pretty simple trick: Once the merger is announced, instruct the target company to hold back revenue until after the merger closes. As a result, the revenue reported by the newly merged company improperly includes revenue that was earned by the target company before the merger.

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Consignment Sales

- With consignment sales, the seller ships goods to a dealer, but still holds legal title to the goods.
- The shipped goods remain on the seller's books as consigned inventory and no sales revenue should be recorded upon the shipment.

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Consignment Sales (cont.)

- When the dealer makes a sale of the goods to a customer, it earns commission revenue.
- The seller then records that sale and transfers the cost of the goods to cost of goods sold.
- If the dealer is unable to sell any or all of the goods, they are returned to the seller and, of course, no revenue is recorded.

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Indirect Methods

- Entail artificial or erroneous decreases to the contra-revenue accounts.
- Contra-revenue accounts are discounts and sales returns and allowances.
- Through decreasing these contra-revenue accounts or by not appropriately increasing these accounts, net sales are artificially inflated and do not reflect an accurate economic picture.

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Search for Analytical Symptoms

- Balances and relationships within the statements
  - Trends in balances
  - Trends in relationships
- Comparisons to non-financial information
  - Trends of company to similar firms
  - Compare recorded amounts to assets they are supposed to represent

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Analytical Procedures

“You can observe a lot just by watching.”

- As spoken by?

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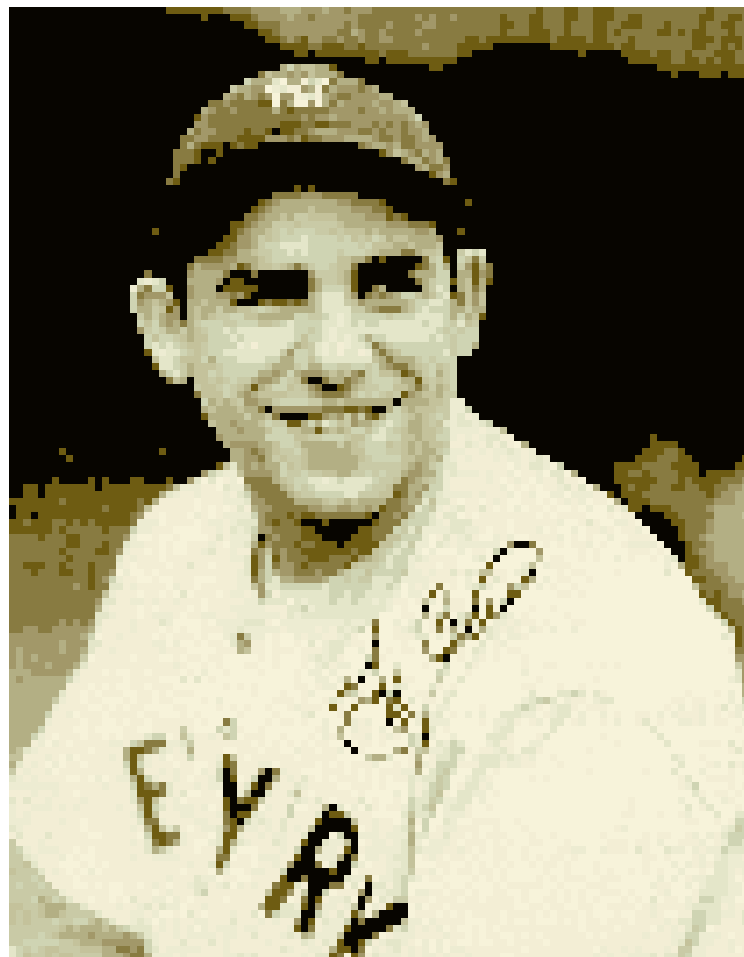
Noted Forensics Expert: Yogi Berra



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Searching for Revenue-Related "Analytical" Symptoms

- **Focusing on <u>Changes in Recorded Amounts</u> Between Periods**
  - **Look at the numbers themselves**
    - **Perform horizontal analysis**
    - **Analyze the statement of cash flows**

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Focusing on Changes in Revenue-Related Relationships

Two primary ways to examine relationships from period to period:

1. **Changes in various revenue-related ratios from period to period (horizontal analysis)**

2. **Common-size statements—vertical analysis**

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Horizontal Analysis

Period to period

- Dollar change
- % change

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Most Commonly Used Ratios

1. **Gross Profit (Margin) Ratio**
2. **Sales Return Percentage**
3. **Sales Discount Percentage**
4. **Accounts Receivable Turnover**
5. **Number of Days in Receivables**
6. **Allowance for Uncollectible Accounts as a Percentage of Receivables**
7. **Asset Turnover**
8. **Working Capital Turnover**
9. **Operating Performance Ratio**
10. **Earnings Per Share**

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Profit Margin Ratios

- Types
  - Net income/net sales
  - Gross profit/net sales
  - Operating profit/net sales
  - Pre-tax profit/net sales
- Can be read directly from percentages on common-sized statements

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Profit Margin

- ***Gross profit/net sales should usually be more consistent than others***
  - ***Can be impacted by operating cost structure and volume changes***
    - ***Fixed vs. variable***
    - ***High-tech vs. low-tech***
  - ***Can be impacted by changes in material prices with no change in actual production activity***

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Red Flags of Revenue Recognition and Fictitious Revenues

- Rapid growth or unusual profitability compared to that of other companies in the same industry

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Red Flags of Revenue Recognition and Fictitious Revenues

- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth

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Common Fraud Indicator

Relationship of reported earnings to cash flow from operations

- Comparison to Industry

- Comparison to Prior Periods

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Why??

- **Earnings overstatement affects other financial statements**
- **Cash is verifiable**
- **Operating cash flow is not as easily misstated**

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Income—Cash Flow Ratio

- **Recommended Ratio (Howard and Ingram Study*)**
  - **[(EBEI+DA) - OCF] / ATA**
  - **[(Earnings Before Extraordinary Items + Depreciation and Amortization) - Operating Cash Flow] / Average Total Assets**

*Don't Forget the Cash Flow; Thomas P. Howard, Ph.D., CFE, CPA, and Robert W. Ingram, Ph.D., CPA; March/April 1996, Vol. 10, No. 2. *Fraud Magazine*

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Examples

- **Kirshner Medical Corporation**
  - **Aggressive growth strategy**
  - **Inventory and sales manipulation**
- **Cascade International**
  - **Company sale of its own stock was recorded as revenue**
  - **Owner disappeared with the cash**

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Example

- Cambridge BioScience Corporation
  - Sales in wrong periods
  - Sales booked that did not meet criteria for recognition

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Examples

- Comptronix Corporation
  - Inflated inventory and reduced COGS
  - Inventory overstatement shifted to PP&E
  - Fake invoices
  - Bogus companies set up as customers and suppliers
  - Bogus and payments and receipts to/from bogus companies by offsetting

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Howard and Ingram Study Findings

- **In all four of the above cases, the Income - Cash Flow Ratio (scaled by assets) was above the 95th percentile for the industry.**
- **It was a better indicator of possible fraud than traditional measures, such as A/R turnover, inventory turnover, asset turnover, and profit margin comparisons.**

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Other Cash Flow Examples

- Enron
  - Cash flow from operations falling
  - Cash from balance sheet items - borrowings
- WorldCom
  - Capitalized line costs
  - Heavy cash flow to PP&E

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Red Flags of Revenue Recognition and Fictitious Revenues

- Significant transactions with related parties or special-purpose entities not in the ordinary course of business, or where those entities are unaudited or are audited by another firm.

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Red Flags of Revenue Recognition and Fictitious Revenues

- Unusual growth in the number of days sales in receivables
- An unusual surge in sales by a minority of units within a company, or of sales recorded by corporate headquarters

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Red Flags of Revenue Recognition and Fictitious Revenues

- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Unusual increase in gross margin or margin in excess of industry peers
- A significant volume of sales to entities whose substance and ownership is unknown
- Unusual decline in the number of days' purchases in accounts payable

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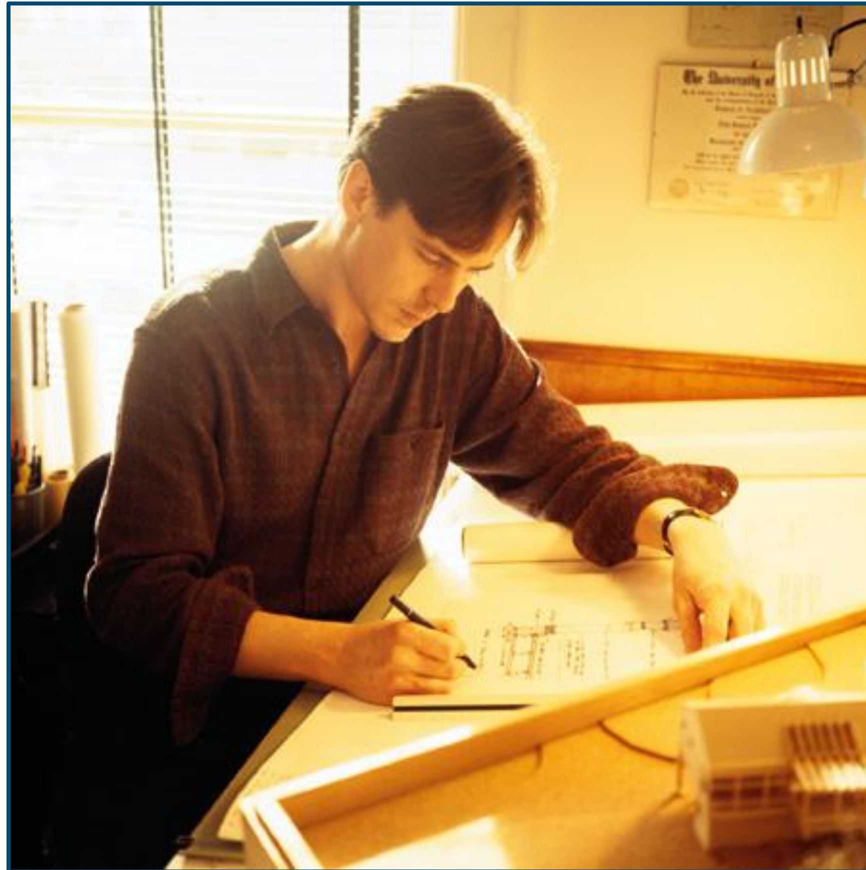
Suggested Interview Questions



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Forensic Accounting Techniques

- Vouching Transactions
  - Examining supporting documentation for selected transactions
- Subsequent Period Review
  - Examining transactions after year-end close
- Cutoff Test
  - Sales and shipping documentation to determine if recorded in the proper period

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