Chapter 3
Fraudulent Financial Reporting

CHAPTER SUMMARY

Overview

The objectives of this chapter are to promote an understanding of reporting fraud, the types that exist, how it comes about, and the motives and personalities of those who perpetrate such fraud.

Importance of Transparent Financial Information

¶3001 An International Problem

Fraud is an international phenomenon touching all countries. Transparency International (TI) is a global network including more than 90 locally established national chapters and chapters-in-formation, whose goal is to fight corruption in the national arena.

¶3005 Statement of Financial Accounting Concepts No. 2

Statement of Financial Accounting Concepts No. 2 provides nine qualities and characteristics that make financial information useful for investors, creditors, analysts, and other users of financial information:

- Relevance
- Timeliness
- Reliability
- Verifiability
- Representational faithfulness
- Neutrality
- Comparability and consistency
- Materiality
- Feasibility or costs and benefits

Zabihollah Razaee believes that reliable financial statements can be achieved with a well-functioning system of corporate governance composed of six groups: the board of directors, the audit committee, the top management team, internal auditors, external auditors, and certain governing bodies (e.g., SEC, PCAOB, AICPA, NYSE, and NASD).

Means and Schemes of Financial Reporting Fraud

¶3011 Three M's of Financial Reporting Fraud

At the highest level, there are three types of fraud that are present in fraudulent financial reporting situations. These types of fraud can be thought of as the three M's of financial reporting fraud: (1) manipulation, (2) misrepresentation, and (3) misapplication.

¶3021 Abusive Schemes Involving Fraudulent Financial Reporting

Fraudulent financial statements compose a small percentage of fraud schemes but pack a major economic and international wallop for investors and employees. Typically, fraudulent statement schemes are perpetrated with the knowledge of— if not the support of—top corporate executives.

Fictitious or Overstated Revenues and Assets. Fraudsters use any of multiple methods to create *fictitious revenues or assets* in order to inflate income on financial statements. A slightly different approach is simply to overstate income—either by omitting elements that would lower actual revenues (such as returns of purchases) or by using mark-to-market accounting to make records of (future) income more "flexible."

Fictitious Reductions of Expenses and Liabilities. Perpetrators improve the bottom line on financial statements using unscrupulous approaches—fictitious reductions of expenses and liabilities—to mask a corporation's true losses or debt. Common approaches to such reductions include the burial of deals likely to generate losses in derivative instruments whose creation does not require an initial cash outflow so their creation does not appear on the books.

Premature Revenue Recognition. *Premature revenue recognition* is a means of recording income as actual in order to inflate earnings totals when sales have not been completed, the products delivered, or invoices paid.

Misclassified Revenues and Assets. Securities investments have been widely misclassified by fraudulent corporate chiefs. GAAP requires investments of debt securities (such as bonds) to be classified as trading, held to maturity, or available for sale. Investments may be classified as held to maturity only if the holder intends to and is able to hold those securities to maturity.

Overvalued Assets or Undervalued Expenses and Liabilities. *Overvalued assets* comprise property for which fraudsters set prices that are unsupportable using standard business valuation approaches. These assets might be bought to essentially pay off parties to which the fraudsters are beholden, sold to artificially boost income, or simply held and recorded on statements at far more than their actual worth.

Omitted Liabilities. *Omitted liabilities* are the mirror image of fictitious revenues and assets: fraudsters hide debt or employ other off-balance sheet financing to avoid having to include the negative picture on corporate financial statements.

Omitted or Improper Disclosures. *Disclosure*, one of the categories of management assertions in financial statements, requires that certain information, such as assets held as collateral and preferred stock dividends in arrears, be included in the notes to financial statements. Fraudsters use *omitted or improper disclosures* to avoid listing questionable or bad news on the balance sheet.

Equity Fraud. *Equity fraud*, also known as *investment* or *securities fraud*, basically involves the promotion and sale of nonexistent or illegal securities investments as well as intentional misrepresentation or concealment of investment and financial related information.

Related-party Transactions. According to AccountingBuzz.com, a *related party transaction* is an interaction between two parties, one of whom can exercise control or significant influence over the operating policies of the other. A special relationship may (and often does) exist between the parties, e.g., a corporation and a major shareholder or parent and subsidiary.

Alter Ego. *Alter ego*, or second self, is an equitable remedy which permits a person to win a dispute against a corporation that the plaintiff does not have standing to sue under regular law.

Minimizing Income or Inflating Expenses to Reduce Tax Liabilities. Although tax evasion is a strong term, less ethical corporations often stretch available deductions or overstate expenses to reduce their tax *liabilities*.

¶3025 Shenanigans to Boost Earnings

Howard M. Schilit describes seven shenanigans; the first five boost current-year earnings, and the last two shift current-year earnings to the future:

1. Recording revenue before it is earned
2. Creating fictitious revenue
3. Boosting profits with nonrecurring transactions
4. Shifting current expenses to a later period
5. Failing to record or disclose liabilities
6. Shifting current income to a later period
7. Shifting future expenses to an earlier period

Sources of Fraudulent Financial Reporting

¶3031 Internal Versus External Fraud

A 1995 KPMG survey provides an excellent illustration by categorizing the sources by internal fraud and external fraud with a further breakdown of management and employee fraud under internal fraud. Table 3.1 shows the various types of fraud in these categories.

Motivation and Contributing Factors

¶3041 Contributing Factor Model

Donald R. Cressey, a student of Edwin H. Sutherland, described three factors contributing to business fraud: motive, opportunity, and lack of integrity (or rationalization). Another view of factors leading to fraud is provided by Zab Razaee in his book *Financial Statement Fraud*. He suggests that financial statement fraud is possible when these three factors are present in a company: conditions, corporate structure, and choice.

¶3051 Risk Factor Analysis

Apostolou, Hassell, and Webber had 35 forensic experts classify the management fraud risk factors from SAS No. 82 as motivation or opportunity. Their results are summarized in Table 3.3. Apostolou, Hassell, and Webber charted characteristics for classifying risk factors as motivation or opportunity, as shown in Table 3.4. Shelton, Whittington, and Landsittel provide a summary of fraud risk factors other than those included in SAS No. 82. Table 3.5 lists the risk factors and the studies that examined them.

¶3061 Internal Controls

Internal controls are perhaps the most essential element in managing risk. The absence or lapse of internal controls in an organization is a tempting open door or opportunity for fraud.

Internal controls were defined in the *COSO Report* as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations."

There are five interrelated components of internal controls:

- Control environment
- Risk assessment
- Control activities or control procedures
- Information and communication systems support
- Monitoring Incidence of Crime and Characteristics of Perpetrators

Incidence of Crime and Characteristics of Perpetrators

¶3071 Studies of the Prevalence of Fraud in Business

An Ernst & Young study of leading companies and public bodies in 32 countries found that more than 50 percent have been victims of fraud in the past year, with 84 percent of total losses attributable to staff and 50 percent of the most serious fraud being committed by the organization's own management. In a 1999 report on fraudulent financial reporting, Beasley, Carcello and Hemanson indicated that the CEO was involved in 72 percent of the cases, the CFO in 43 of the cases, and the CEO/CFO 83 percent of the time.

