First Friday Fraud Facts+

August 2, 2013

The Idaho State Controller's Office distributes this newsletter as a cost-effective method of increasing awareness about ways to detect and prevent fraud, waste, and abuse in government.

Welcome to First Friday Fraud Facts+ (F4+). This edition will cover financial statement fraud.

Financial Statement Fraud

Financial statement fraud occurs when a person intentionally deceives financial statement users by deliberately omitting or misstating amounts or note disclosures in the financial statements.

A variety of reasons exist that might cause a person to commit financial statement fraud. Some reasons may include:

- To obtain financing or to obtain more favorable financial arrangements for the company or organization on existing debt.
- To obtain a more favorable contract from government.
- To meet performance goals and objectives in order to receive bonuses or pay raises.
- To satisfy managers or directors of the entity.
- To hide illegal activity.

Types of Financial Statement Fraud

Several ways people commit financial statement fraud include:

- Overstating assets (e.g. inventory, accounts receivable, cash, investments, etc.).
- Overstating revenues or earnings.
- Underreporting liabilities (e.g. accounts payable, notes payable, etc.).
- Underreporting expenses.
- Reporting inadequate or complex disclosures.

Other types of financial statement fraud:
An entity may understate revenues or overstate expenses in order to reduce their tax liability.

Questions or Comments:

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RED FLAGS

Some things to look for when checking for financial statement fraud:

- Weak internal controls
- Complex transactions
- Extraordinary or unusual revenue growth
- Sales reported without any corresponding cost of goods sold
- Expenses reported in the incorrect period
- Unusual increase in number of days sales in receivables or unusual decrease in number of days purchases in accounts payable
- Improper inventory valuation
- Fictitious fixed assets or improper value on fixed assets
- Allowances for sales returns, warranty claims, etc., are not in line with industrial averages
- Inadequate or complex disclosures[1]

FRAUD CASE

For nearly two years, a Chief Financial Officer (CFO), who was pressured by the Chief Executive Officer (CEO) to meet the company's financial projections, used a variety of fraudulently creative accounting schemes in order to increase the company's financial position and its stock price. The CFO's primary motive for committing financial statement fraud was to please the CEO.

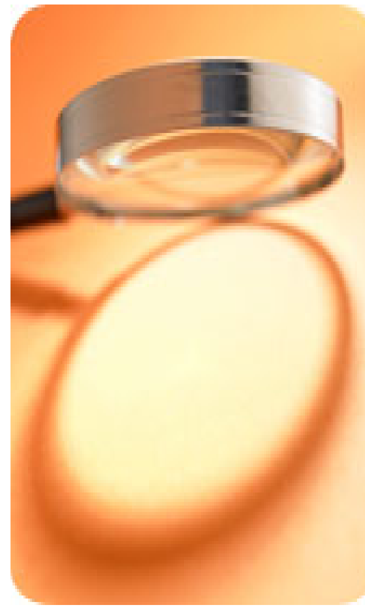
The CFO initially used minor accounting tricks to improve the company's bottom line, with the intent of reversing them in later accounting periods. However, the situation eventually escalated and he subsequently used more complex fraudulent accounting tactics to cover his tracks.

One of the tactics he used involved creating false invoices in order to record sales transactions that never occurred. To record a false invoice, the CFO would input a fictitious customer name, item description, unit price, quantity, and sale date into the accounting system. The system would then record a sale with a corresponding account receivable. When cash was received from an unrelated transaction, the CFO would book the cash to the fraudulent receivable rather than to the valid related receivable. As a result, the fraudulent receivable would show paid off by year-end.

In another tactic, the CFO would record fictitious sales with no corresponding cost of goods sold (COGS). To do this, he would exclude the inventory numbers on the false invoices or he would create a manual journal entry to reverse the COGS reported by the system. The net result was a 100 percent profit margin from the fictitious sales.

The scheme was eventually discovered by a member of the financial press. The CFO was convicted and served five years in prison for securities fraud.[2]

Fiscal Focus-Testing for Financial Statement Fraud



Governmental agencies should be aware of the potential for financial statement fraud by an entity bidding for governmental contracts. Agencies may consider reviewing the financial statements and making necessary inquiries of bidding contractors or vendors to test for financial statement fraud. The Idaho Department of Administration has issued instructions which explain the state's right to request specific information, including financial statements, from vendors. The instructions can be found at the following website:
http://purchasing.idaho.gov/terms_and_conditions.html

[1] Association of Certified Fraud Examiners. *Financial Statement Schemes*. 2007 Fraud Examiners Manual. pp. 1.301-1.351.

[2] Lambiras, Jon J. (2013) . *How a CFO landed in prison*. http://www.acfe.com/article.aspx?id=4294976271. Accessed June 10, 2013.