



Financial Statement Fraud (FSF) FSF4

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Topics

1. Introduction
2. Fraud Risk Assessment
3. Frequent Financial Statement Fraud Schemes
4. Occupational Fraud
5. Selected Additional Financial Statement Fraud Cases

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Unit 1

Introduction



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Introduction

Learning Objectives

After completing this unit, participants will be able to:

- Define fraud in the context of financial statement fraud.
- Describe examples of fraudulent financial reporting.
- Describe managements and the auditor's responsibilities in the areas of fraud prevention and detection.
- Describe the Fraud Triangle and its implications for financial statement fraud.
- Recognize both soft and hard indicators of fraud.

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Types of Fraud

- Management Fraud – more financial statement focused; override of internal controls
- Occupational Fraud – more focused on theft of assets



Definition of Fraud – Page 2

*A deliberate false intentional misstatement of a matter of fact—
fraudulent financial reporting and misappropriation of assets—
whether by words or by conduct, by false or misleading allegations,
or by concealment of what should have been disclosed, that
deceives and is intended to deceive others so that the individual will
act upon it to their advantage*



Definition of Fraud

- Deliberate false statement
- Intentional fraud
- Fraudulent financial reporting
- Misappropriation of assets
- Concealment



Definition of Fraud

- Fraudulent red flags – Page 3
- Fraudulent financial reporting – Page 3



Fraud Cases

Cardinal Health
HealthSouth
Tyco
Kraft Heinz Co.



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Discussion Question—Cardinal Health, Inc.

How can a company commit financial statement fraud for almost 4 years without its being discovered?

Tone at the Top – Corporate Culture

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Discussion Question—Health South

In your professional experience, have you ever seen one individual dominate a large business such that their actions are not questioned or challenged?



Responsibility for Fraud Prevention and Detection – Page 9

1. Board of Directors and audit committee
2. Internal audit
3. External audit
4. Management—Tone at the Top



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Fraud Theory

- Fraud motivators – Pages 10 and 11
- Fraud Triangle – Pages 11 and 12

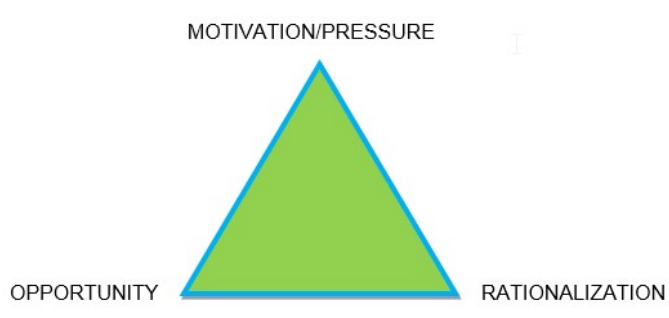
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Fraud Triangle



MOTIVATION/PRESSURE

OPPORTUNITY

RATIONALIZATION

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Soft and Hard Indicators of Fraud – Pages 12 and 13

- Soft indicators of fraud
- Hard indicators of fraud

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Who Commits Fraud?

- Age of fraudster—between 36 and 55
- Overwhelmingly male
- Generally a member of management
- Works in finance or operations/sales and is frequently the CEO
- Time with the organization—33% over 10 years, 56% between 3 and 10 years
- Fraud was committed in collusion with others 61% of the time
- Internal controls were overridden in 74% of the cases

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Unit 2

Fraud Risk Assessments



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Fraud Risk Assessments

Learning Objectives

After completing this unit, participants will be able to:

- Develop an appreciation for the importance of performing fraud risk assessments as a deterrent to financial statement fraud
- Describe the five principles included in *Managing the Business Risk of Fraud: A Practical Guide* report
- Identify fraud risk factors associated with financial statement fraud

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Fraud Risk Assessments

Fraud Risk Factors – Pages 15-16

- Fraud risk assessment is a process of proactively identifying and addressing an organization's vulnerabilities (fraud risks) to internal and external fraud-the objective of which is to help an organization identify what makes it most vulnerable to fraud



Fraud Risk Assessments

Fraud Risk Factors – Page 16

- Management override of internal controls
- Changing assumptions or judgments supporting significant estimates
- Backdating purchase or sales agreements
- Fictitious or unapproved journal entries
- Partial shipments of inventory to customers



Fraud Risk Assessments

Fraud Risk Factors (cont'd) – Page 16

- Unnecessarily complex transactions
- Related party transactions
- Unusual nonrecurring transactions
- Poor tone at the top (management)
- Delayed closing of the books

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Managing the Business Risk of Fraud: A Practical Guide

Five Principles - Pages 16 -17

1. As part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk
2. Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate

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Managing the Business Risk of Fraud: A Practical Guide

Five Principles (cont'd)

3. Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization
4. Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized

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Managing the Business Risk of Fraud: A Practical Guide

Five Principles (cont'd)

5. A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure that potential fraud is addressed appropriately and timely

Demonstrating the proper Tone at the Top

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Fraud Risk Factors

Fraud Triangle

1. Motivation/pressures – Pages 17-18
2. Opportunities – Pages 19-20
3. Attitudes/rationalization – Page 21



Fraud Cases

WorldCom

Koss Corporation

**Adelphia
Communications**

Rite Aid





Discussion Question—WorldCom

How can a company report internally \$11 billion of plant and equipment that it does not have?

Massive management cover up

Consider the cash flow statement

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Discussion Question—Koss Corporation

Why would ownership turn operations over to one individual without any effective oversight or control of the individual?

Trusted employee

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Discussion Question—Adelphia Communications

Are you aware of organizations where there is no distinction between personal and business transactions? If yes, are third parties affected?

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Discussion Question—Rite Aid

Why do you think it took 3 years before this financial statement fraud was discovered?

Massive management cover up

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Fraud Risk Assessments

- Importance of inquiries – Pages 23-25

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Unit 3

Frequent Financial Statement Fraud Schemes



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Frequent Financial Statement Fraud Schemes

Learning Objectives

After completing this unit, participants will be able to:

- Identify examples of schemes and methods used by fraudsters to commit financial statement fraud
- Identify red flags of financial statement fraud



Introduction

Fraud Schemes

- Improper revenue recognition
- Improper asset recognition or valuation
- Concealed liabilities and expenses
- Improper financial statement disclosures



Introduction

Four Common Techniques in the Majority of Financial Statement Frauds

1. Misuse of journal entries
2. Management override of controls
3. Intentional misstatements of accounting estimates
4. Existence of unusual transactions



Financial Statement Red Flags

Pages 28-29



Improper Revenue Recognition

COSO Report – Page 29

- The companies in the study had median sales of approximately \$72 million and median company income approximating \$875,000
- In 72% of the cases, the CEO was involved in the frauds and the CFO was involved in
- Most frauds were not isolated in a single period but impacted at least two consecutive periods
- Majority of the fraudulent activity took place close to or as of the end of the fiscal year
- 60% of the frauds involved overstating revenues by recording revenues prematurely or fictitiously

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Improper Revenue Recognition

COSO Report (cont'd) – Motivations – Page 30

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Conceal the organization's deteriorating financial position
- Maintain or increase the stock price
- Improve financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

Tangoe Inc.

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Improper Revenue Recognition Practices

Four Categories

1. Fictitious revenue – Pages 31-33
2. Overstating revenue – Page 33
3. Understating revenue – Page 34
4. Premature revenue recognition – Pages 34-35

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Fraud Cases

Wirecard
General Electric
MiniScribe
Groupon, Inc.
Tesco PLC
Cantaloupe
Bristol-Meyers
Squibb



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Discussion Question—Wirecard

Are you surprised by the scope of the Wirecard fraud, given the notoriety of the company?



Discussion Question—General Electric

While the motivation was clearly to improve operating results, given the size of the fraudulent activity, do you think senior management had to approve these transactions?



Discussion Question—Groupon

Given Priceline.com's gross versus net experience previously, what do you think motivated Groupon's management to account for commission transactions this way?



Improper Revenue Recognition

- Red Flags – Page 35



Improper Asset Recognition or Valuation – Pages 36-37

1. Improper asset recognition
 - Misappropriation of assets
 - Fictitious assets – Chambers Development
 - Misclassification
2. Improper valuation of assets

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Improper Asset Recognition or Valuation – Pages 36-37

Improper Valuation of Assets

- Inventory
- Accounts Receivable
- Business Combinations
- Asset Impairments
- Goodwill Impairments

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Fraud Cases

**Federal National
Mortgage
Association
Phar-Mor
Caterpillar Inc.
Cendant
Corporation
Future Fin Tech
Group
Devon Energy (no
fraud)**

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Discussion Question—Phar-Mor

This financial statement fraud took place over 20 quarters and 5 annual financial statement fiscal years. How could a fraud of this significance be missed by all the parties involved?

Massive management cover up
Incompetent auditors

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Improper Asset Recognition or Valuation

- Red Flags – Page 44

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Concealed Liabilities and Expenses – Pages 45-48

1. Granite Construction
2. Adelphia Communications
3. Cookie jar reserves

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Concealed Liabilities and Expenses – Pages 45-48

- Recording and classifying expenses as assets—capitalizing expenses (note WorldCom, Rite Aid)
- Placing debt in unconsolidated off-balance sheet entities (Enron)
- Reporting debt incurred as revenue
- Simply not recording expenses or debt as incurred
- Increased involvement with related parties
- Failing to record or disclose contingent liabilities
- Overstate liabilities by establishing cookie jar reserves – Pages 46-47

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Concealed Liabilities and Expenses

- Red flags – Page 48



Improper Financial Statement Disclosures – Pages 49-54

- Not disclosing the existence of loan covenant restrictions
- Not disclosing the existence of contingent liabilities or guarantees made
- Not disclosing the fair values of financial instruments that have become impaired
- Not disclosing subsequent events that occur after year-end that might include legal settlements, impaired assets, or economic events that could negatively impact the reported results
- Not disclosing the existence of and the activity with related parties
- Not disclosing or reflecting in the financial statements the results and impact of a change in accounting principle or a change in an accounting estimate in order to present misleading financial statements
- Committing financial statement fraud to overstate or understate earnings and concealing the financial statement fraud by not disclosing it



Improper Financial Statement Disclosures – Pages 49-54

- Enron
- Tyco

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Improper Financial Statement Disclosures

- Red Flags – Page 54

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Unit 4

Occupational Fraud



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Occupational Fraud

Learning Objective

After completing this unit, participants will be able to:

- Describe the Association of Certified Fraud Examiners 2022 Report to the Nations.



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2022 Report to the Nations – Pages 56-58

3 Categories of Occupational Fraud:

1. Corruption
2. Asset misappropriation
3. Financial statement fraud

An organization loses 5% of their revenue to fraud



2022 Report to the Nations

Three Categories of Occupational Fraud

- Asset misappropriation—86% of the time with a median loss of \$100,000
- Corruption—50% of the time with a median loss of \$150,000
- Financial statement fraud—9% of the time with a median loss of \$593,000



2022 Report to the Nations

Asset Misappropriation Schemes

- Billing—20%
- Non-cash (assets)—18%
- Expense reimbursements—11%
- Check and payment tampering—10%
- Skimming—9%

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2022 Report to the Nations

Asset Misappropriation Schemes (cont'd)

- Cash on hand—9%
- Payroll—9%
- Cash larceny—8%
- Register disbursements—3%

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2022 Report to the Nations

Corruption Schemes

The industries with the highest proportion of corruption cases include:

- Energy
- Manufacturing
- Transportation warehousing

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2022 Report to the Nations

More than half of all occupational frauds came from these four departments:

- Operations—15%
- Accounting—12%
- Executive/upper management—11%
- Sales—11%

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2022 Report to the Nations

Concealment Methods

1. Created fraudulent physical documents—39%
2. Altered physical documents—32%
3. Created fraudulent electronic document or files—28%
4. Altered electronic documents or files—25%
5. Destroyed or withheld physical documents—23%

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2022 Report to the Nations

Occupational Fraud Is Initially Detected

- Tip—42%
- Internal audit—16%
- Management review—12%
- Document examination—6%
- By accident—5%
- Account reconciliation—5%

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2022 *Report to the Nations*

Occupational Fraud Is Initially Detected (cont'd)

- External audit—4%
- Automated transaction/data monitoring—4%
- Surveillance/monitoring—3%
- Notified by law enforcement—2%
- Confession—1%
- Other – 1%

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Weaknesses in Internal Control

- Lack of internal controls—29%
- Overridden internal controls—29%
- Lack of management review—16%
- Poor tone at the top—10%
- Lack of competent personnel in oversight roles—8%
- Other – 7%
- Lack of independent checks/audits—5%

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Behavioral Red Flags – Page 59

- Living beyond their means—39%
- Had financial difficulties—25%
- Had an unusually close association with vendors/customers—20%
- No behavioral red flags
- Exhibited control issues; unwilling to share duties and responsibilities—13%

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Behavioral Red Flags

- Irritability, suspiciousness, or defensiveness—12%
- Bullying or intimidation – 12%
- Had divorce or family issues—11%
- Wheeler dealer attitude—10%

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2022 Report to the Nations

Cryptocurrency Schemes – Page 59

8% of fraud cases involved the use of cryptocurrency

- Making bribery and kickback payments—48%
- Converting misappropriated assets to cryptocurrency—43%



Discussion Question—2022 Report to the Nations

Do you agree with this report that your organization is losing 5% of revenue a year to customer and employee theft? If not, how are you preventing it?

Unit 5

Selected Additional Financial Statement Fraud Cases



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Selected Additional Financial Statement Fraud Cases

Learning Objective

After completing this unit, participants will be able to:

- Recognize the most common financial statement fraud activities through selective case analysis



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Selected Additional Financial Statement Fraud Cases

Fraud Cases

- Four Seasons Nursing Centers of America
- MiniScribe
- Informix Corporation
- Computer Associates
- Lernout & Hauspie Speech Products
- Baptist Foundation of Arizona

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Selected Additional Financial Statement Fraud Cases

Fraud Cases (cont'd)

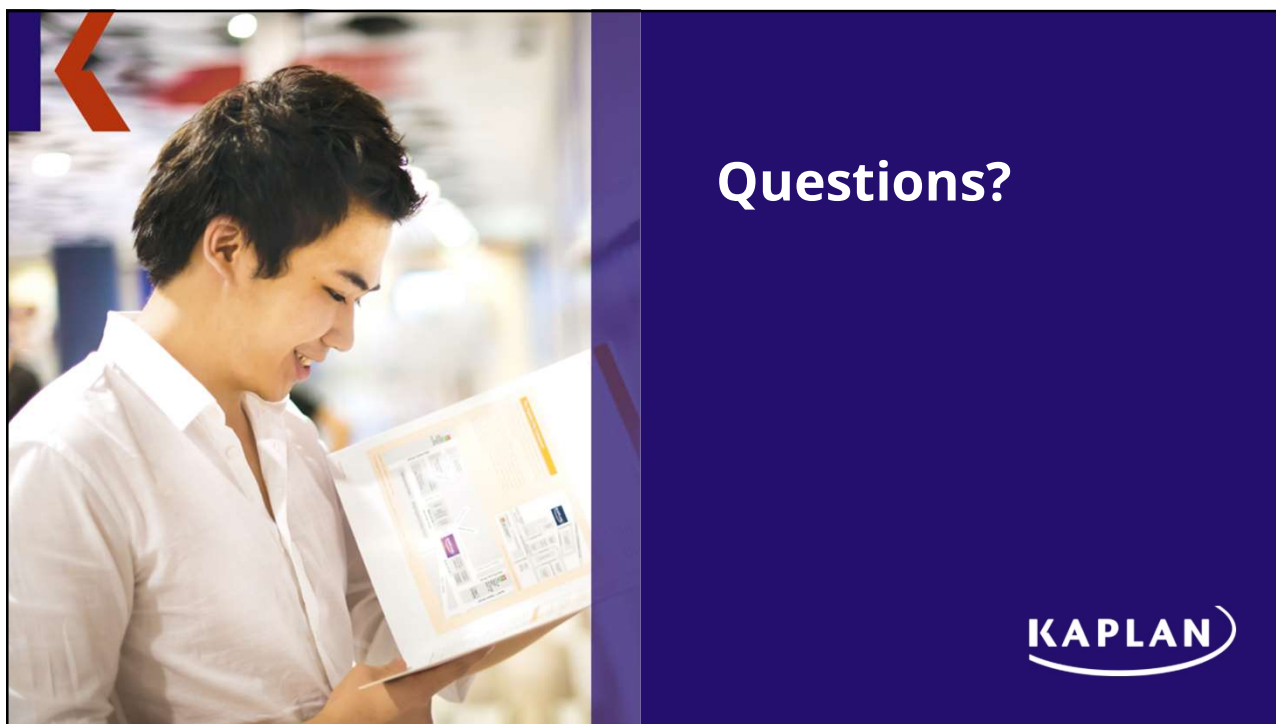
- Peregrine Systems, Inc.
- Mercury Finance Company
- Sunbeam Corporation
- Anicom, Inc.
- Parmalat
- Olympus Corporation

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Reminders

☐ **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!

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