Deceptive Accounting Practices

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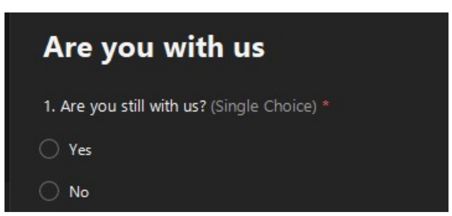
Tips for a Successful Experience

- **Technical Difficulty?** Try refreshing your page, reconnecting to the class, or rebooting (chat the moderator if you do this, so they can keep track of your presence). Also, logging in under your company's VPN may cause technical difficulty. Turn off your pop up blocker! Tech Support Team 866.265.1561 Option 1 then Option 2
- **Earning CPE:** Throughout the presentation a presence manager will pop up to check your attendance. Answer the questions with the appropriate response to record your attendance. Credit is earned by acknowledging 75% of these pop-ups per hour.



- **Chats:** You may be asked to reply to the moderator in the chat box to confirm attendance. Please be aware of any chats.
- **Questions:** Use the Chat box to ask any questions you may have about today's webcast. Someone is available to assist with your technology related concerns. The instructor will address your content related questions during the presentation or follow up after.
- **Once you are logged in please do not log out even during breaks.**

Unit 1

Overview

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Learning Objectives

- Identify and describe factual situations and examples leading to deceptive accounting practices associated with financial reporting

Introduction

- Rio Tinto for inflating the value of coal assets acquired for $3.7 billion and sold a few years later for $50 million
- PharMor's inappropriate quarter-end journal entries to debit inventory and credit sales to achieve performance targets for the drug store chain
- Longtop Financial Technologies Limited and its auditor, Deloitte Touche Tohmatsu CPA Ltd.
- HP's allegations of pre-acquisition financial-reporting fraud by the software company Autonomy.
- Osiris Therapeutics overstating the company's performance

Introduction

- Creative accounting practices
- Fraud is not an isolated instance; Fraud is intentional and tends to occur over a period of time

Financial Statement Fraud Examples

HealthSouth

Tyco International Ltd

Introduction

2022 Report to the Nations on Occupational Fraud and Abuse

- The typical organization loses 5% of its revenue to fraud each year, which approximates global fraud losses of nearly $4.7 trillion loss with an average loss per case being $1,783,000
- The frauds reported in the study lasted between 12 and 18 months before being detected
- The industries most commonly victimized were real estate, wholesale trade, transportation and warehousing, construction, and utilities
- Fraudsters with higher levels of authority tend to cause significantly larger losses

Introduction

2022 Report to the Nations on Occupational Fraud and Abuse (cont'd)

- The longer a fraudster has worked for an organization, the higher the fraud losses tend to be
- Most fraudsters are first-time offenders with clean employment histories
- Approximately 76% of the frauds were committed by individuals working in one of eight departments: operations, accounting, executive/upper management, sales, customer service, purchasing, administrative support, and finance

Unit 2

Introduction to Fraud Theory

Learning Objectives

- Define fraud in the context of financial statement fraud
- Describe management's 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

Introduction to Fraud Theory

- Management Fraud
- Occupational Fraud

Introduction to Fraud Theory

Fraud

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 his or her advantage

Introduction to Fraud Theory

Fraud (cont'd)

- Deliberate False Misstatement
- Fraud is Intentional
- Fraudulent Financial Reporting
- Misappropriation of Assets
- Concealment

Introduction to Fraud Theory

Fraudulent Red Flags

- Incentive compensation plans linked to performance
- Management dominated by a single individual or a small group
- Management sets unrealistic or aggressive financial goals
- Past history of fraudulent activity or illegal activity
- Unusual, one-time transactions recorded during an accounting period

Examples of Fraudulent Financial Reporting

Fraud

Cardinal Health

Introduction to Fraud Theory

Responsibility for Fraud Prevention and Detection

- Board of directors and audit committee
- Internal audit
- External audit
- Management – Tone at the Top

Fraud

Colonial Bank

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Introduction to Fraud Theory

COSO Framework

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities

Introduction to Fraud Theory

COSO Framework – Fraudulent Reporting

1. Fraudulent financial reporting
2. Fraudulent non-financial reporting
3. Misappropriation of assets
4. Illegal acts

Introduction to Fraud Theory

COSO Framework – Risk Assessment Considerations

- Management bias; for instance, when selecting or applying accounting principles
- Degree of estimates and judgments used in financial reporting
- Fraud schemes and scenarios common to the industry and markets in which the company operates
- Geographic regions when the company does business

Introduction to Fraud Theory

COSO Framework – Risk Assessment Considerations (cont'd)

- Company incentives that may motivate fraudulent behavior
- Nature of the company's technology and management's ability to manipulate information
- Unusual or complex transactions subject to significant management influence
- Vulnerability to management's override and potential schemes to circumvent existing internal controls

Introduction to Fraud Theory

- Greed
- Need
- Entitled
- Abused

Fraud

Example Mary

Introduction to Fraud Theory

Corporate Fraud Motivators

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Comply with debt covenants
- Conceal the company's deteriorating financial condition

Introduction to Fraud Theory

Corporate Fraud Motivators (cont'd)

- Maintain or increase the company's stock price
- Improve the company's financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

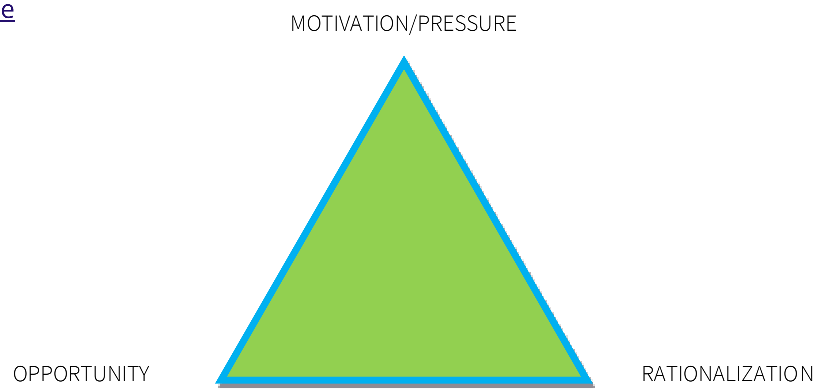
Introduction to Fraud Theory

Fraud Triangle

- Motivation/Pressure
- Opportunity
- Attitude/Rationalization

Introduction to Fraud Theory

Fraud Triangle



Introduction to Fraud Theory

Soft Indicators of Fraud

- Risk taker
- Likes to “beat the system”
- Refusal to take time off
- Coming in early/staying late
- Drug/alcohol abuse

Introduction to Fraud Theory

Soft Indicators of Fraud (cont'd)

- Lavish lifestyle
- Personal financial problems
- Divorce/family problems
- Self-control issues

Introduction to Fraud Theory

Hard Indicators of Fraud

- Discrepancies in accounting records
- Conflicting or missing documentation
- Frequent changes in accounting estimates
- Frequent resignations of accounting or finance personnel
- Transactions not completed in a complete or timely manner
- Unsupported or unauthorized balances or transactions

Introduction to Fraud Theory

Hard Indicators of Fraud (cont'd)

- Last minute adjustments that significantly affect accounting results
- Evidence of management override
- Unexplained differences between subledgers and control accounts
- Missing inventory or other physical assets
- Financial reporting results significantly different from competitors in the same industry

Introduction to Fraud Theory

Who Commits Fraud?

- Age of fraudster – between 36 and 55
- Overwhelmingly male
- Generally, a member of management
- The fraudster 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 69% of the time
- Internal controls were overridden in 74% of the cases

Unit 3

Revenue Recognition

Learning Objectives

- Identify and describe examples of improper revenue recognition
- Anticipate revenue recognition challenges associated with Topic 606, *Revenue from Contracts with Customers*

Revenue Recognition

- SAB 104: *Revenue Recognition in Financial Statements* – SEC, 2003
- *Fraudulent Financial Reporting*: 1998-2007, An Analysis of U.S. Public Companies – COSO, 2010
- *Fraud Risk Management Guide* – COSO 2016
- ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606) - FASB
- *Auditing Revenue in Certain Industries* – AICPA, 2012 – Note this guide has been replaced by *Revenue Recognition – Audit and Accounting Guide* published in 2018 reflecting the new revenue guidance found in Topic 606, *Revenue from Contracts with Customers*
- *Mitigating the Risk of Common Fraud Schemes: Insights from the SEC Enforcement Actions* – January 2021, SEC

Revenue Recognition

Revenue from Contracts with Customers (Topic 606)

1. Identify the contract(s) with a customer
2. Identify the performance obligation(s) in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the reporting entity satisfies a performance obligation
6. Disclosure requirements

Revenue Recognition

Revenue from Contracts with Customers (Topic 606) – Risk of Fraudulent Material Misstatement

- Determining if revenue is recognized in compliance with the six-step model (risk is that revenue may be recognized even though the customer has not taken control of the good or service)
- Determining if a contract exists between the company and customers (lacking a contract, the company would recognize revenue only as cash is received)
- Determining if contract modifications are being accounted for properly and consistently (certain modifications could result in additional distinct performance obligations being created)

Revenue Recognition

Revenue from Contracts with Customers (Topic 606) – Risk of Fraudulent Material Misstatement (cont'd)

- Determining how performance obligations are identified and satisfied and whether the conclusions as to whether they are "distinct" or stand-alone or not appropriate (risk is that companies may aggregate performance obligations to accelerate revenue)
- Determining if any variable consideration exists in the contract and it has been accounted for in the proper time period and in the correct amount (risk is that variable consideration will be recognized prematurely or recognized when it should be deferred until it is probable of occurring)

Revenue Recognition

Revenue from Contracts with Customers (Topic 606) – Risk of Fraudulent Material Misstatement (cont'd)

- Determining the transaction price based on stand-alone selling prices and allocating it correctly to the performance obligations (risk is that allocations will occur that accelerates the recognition of revenue)
- Identifying evidence supporting recognizing revenue over time – transfer of control (risk is that the evidence developed may not agree to the contract terms)

Revenue Recognition

Improper Revenue Recognition

- Improper revenue recognition can be attributable to the timing and valuation of revenue including fictitious revenues and pattern of revenue recognition for long-term contracts

Improper Revenue Recognition Examples

Leap Wireless International

Tesco Plc

Qwest Communications International

iGo

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Revenue Recognition

Improper Revenue Recognition Practices

- Falsifying customers or their contracts
- Accelerating revenue in a current period even though all recognition criteria were not met
- Recognizing revenue when inventory was shipped on consignment
- Failing to account for extended terms, concessions, or discount side-agreements
- Improperly applying percentage of completion to long-term contracts
- Engaging in channel stuffing

Improper Revenue Recognition Example

OCZ Technology Group

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Revenue Recognition

Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies

- 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 65% of the cases
- 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

Revenue Recognition

Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies

Motivations:

- Meet external earnings expectations of analysts and others
- Meet internally set financial targets
- Conceal the entity's deteriorating financial position
- Maintain or increase the stock price

Revenue Recognition

Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies

Motivations (cont'd):

- Improve financial position to support future equity or debt financing
- Achieve performance targets needed to obtain incentive compensation
- Hide the theft of assets

Improper Revenue Recognition

Indicators

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Improper Revenue Recognition

Practices

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Revenue Recognition

SAB 104

1. Side agreements
2. Risk and rewards of ownership (now control) have not been transferred to the buyer – General Electric
3. Bill and holds
4. Delivery is made to an intermediate site
5. Uncertainty exists about customer product acceptance
6. Transfer of control

Revenue Recognition

SAB 104 (cont'd)

7. Delivery or performance of multiple deliverables
8. Licensing agreements
9. Layaway transactions
10. Non-refundable or up-front fees
11. Service revenue
12. Contingent revenue contract

Improper Revenue Recognition Case

Xerox Corporation

Improper Revenue Recognition Case

Axesstel, Inc.

Revenue Recognition

Other Deceptive Revenue Recognition Practices

- Fictitious Revenue
- Gross vs. Net Issue (Principal vs. Agent)
- Channel Stuffing or Trade Loading
- Back (or Forward) Dating Sales

Fictitious Revenue Examples

Centennial Technologies

Cisco Systems

Mini-Scribe

ZZZZ Best

Gross vs Net Issue Examples

Priceline.com

Groupon, Inc.

Channel Stuffing or Trade Loading Examples

Bristol-Myers Squibb

McAfee, Inc.

Back (or Forward) Dating Sales Examples

Qwest Communications International

Donnkenny

Sensormatic Electronics, Inc.

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Misleading Revenue Disclosures

Under Armour, Inc.

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Unit 4

Estimates – Reserves, Asset Impairments, and Accruals

Learning Objectives

- Identify and describe deceptive accounting practices in the area of reserves, asset impairments, and accruals
- Describe estimate deceptive accounting techniques used by Cendant and Rite Aid

Estimates – Reserves, Asset Impairments, and Accruals

Estimate Abuse

1. Failure to record adequate amounts to avoid the negative impact on earnings:
   - Ikon Office Solutions
   - Cisco Systems
   - Rite Aid
   - Hertz Global Holdings

Estimates – Reserves, Asset Impairments, and Accruals

Estimate Abuse (cont'd)

2. Recording excess reserves up front to provide a "rainy day" fund for the future:
   - Cendant
   - Sunbeam

- Cookie Jar Accounting Schemes – Beazer Homes USA

Estimates – Reserves, Asset Impairments, and Accruals

Reserves Manipulation

- Manipulating cost of goods sold by moving costs out of cost of goods sold to inflate margins
- Improper reduction or manipulation of reserves, including accounts receivables and rebates
- Increasing inventory amounts on the balance sheet to manage financial metrics or overall results by including overcapitalizing costs into inventory thereby inflating its value; the timing of inventory reserves and failing to record losses when cost exceeds market value
- Deferring the recognition of loan impairments by creditors

Estimates – Reserves, Asset Impairments, and Accruals

- Accounts and Loans Receivable:
  - Santander
- Inventory:
  - VeriFone Holdings Inc.
  - Stein Mart

Estimates – Reserves, Asset Impairments, and Accruals

- Vendor Rebates:
  - Rite Aid
  - Royal Ahold NV
  - Office Depot
  - Saks Inc.
- Other Reserves:
  - Cardinal Health

Estimates – Reserves, Asset Impairments, and Accruals

- Restructuring Reserves:
  - Printek Corporation
  - Cendant Corporation
  - Rite Aid Corporation

Estimates – Reserves, Asset Impairments, and Accruals

- Asset Impairments for Long-Lived Assets That are Depreciated or Amortized (Triggering Events):
  - Direct TV
- Goodwill and Other Indefinite-Lived Intangible Assets:
  - KB Industries

Questions for Discussion

KB Industries

Estimates – Reserves, Asset Impairments, and Accruals

- Accruals:
  - Livent
  - New York Times
- Fair Value Estimates:
  - The Federal National Mortgage Association

Questions??

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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