

Sage



FORENSIC ACCOUNTING



Outdoor Retailer Conference
Financial Statement Fraud

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About Sage Forensic Accounting

Sage Forensic Accounting quantifies damage claims in litigation, determines value, and advises on related issues. Sage provides four core skills:

- Forensic and investigative accounting – uncovering the facts
- Economic loss calculation – getting behind the numbers
- Financial valuation – determining business value
- Computer Forensics – conducting computer investigations

Offices:

Salt Lake City, Las Vegas, Boise



Documents commonly used to detect fraud in Investigative Accounting Assignments

- Federal and state tax returns
 - Partnerships
 - “S” Corporations
 - “C” Corporations
 - Individual tax returns, including all schedules
- Monthly, quarterly, and annual financial statements
 - Balance sheets
 - Income statements
 - Cash flow statements
 - General ledgers & other subsidiary ledgers

Financial Statement Fraud

- Financial Statement Fraud is the ***deliberate misrepresentation*** of the financial condition of an enterprise accomplished through the ***intentional misstatement*** of ***omission*** of amounts or disclosures in the financial statements to ***deceive*** financial statement users.

Why Financial Statement Fraud Is Committed

- To demonstrate increased earnings.
- To cover inability to generate cash flow.
- To dispel negative market perceptions
- ***To obtain financing, or to obtain more favorable terms on existing financing.***
- To meet company goals and objectives, and
- To receive performance-related bonuses.

Trends in Financial Statement Fraud

- According to 2010 *Report to the Nation on Occupational Fraud and Abuse*, fraudulent statements comprised of 4.3% of the frauds reported in the study, with a median loss of \$1,730,000.
- Financial Statement Fraud has lowest occurrence but highest loss.

Financial Statement Fraud Schemes

- Fraud in Financial Statements Typically 2 Forms:
 - Overstating Assets or Revenues
 - Understated Liabilities and Expenses
- Both methods result in increased equity and net worth of the company

Financial Statement Fraud Schemes cont.

- 5 Classifications of Financial Statement Schemes:
 - **Fictitious Revenues**
 - Timing Differences
 - **Improper Asset Valuations**
 - **Concealed Liabilities and Expenses**
 - Improper Disclosures

Fictitious Revenues

- Fictitious or fabricated revenues involve the recording of sales of goods or services that did not occur.
- Red Flags:
 - **Rapid growth** or **unusual profitability**, especially compared to that of other companies in the same industry.
 - **Recurring negative cash flow** from operations or an inability to generate positive cash flows from operations while reporting earnings and earnings growth.
 - **Significant transactions with related parties** or special purpose entities not in the ordinary course of business.
 - **Changes in Retained Earnings** or **Equity**.

Fictitious Revenues, cont.

- **Significant, unusual, or highly complex transactions**, especially **close to the period's end** that pose difficult “substance over form” questions
- **Unusual growth in the days' sales in receivables ratio**
=(receivables/average daily sales)
- **A significant volume of sales to entities whose substance and ownership is not known.**
- **An unusual surge in sales** by a minority of units within the company.

Improper Asset Valuations

- Most improper asset valuations involves the fraudulent overstatement of inventory or receivables, misclassification of fixed and other assets, or improper capitalization of inventory or start-up costs.
- Red Flags:
 - **Recurring negative cash flow** from operations or an inability to generate positive cash flows form operations while reporting earnings and earnings growth.

Improper Asset Valuation, cont.

- **Unusual increase in gross margin** or margin in excess of industry peers.
- **Unusual growth** in the **number of days' sales in receivables ratio**.
- **Unusual growth** in the **number of days' purchases in inventory ratio**.
- **Reduction** in **allowances for bad debts, excess inventory, obsolete inventory, etc.**
- **Unusual change** in the relationship **between fixed assets and depreciation**.

Improper Asset Valuation, cont.

- **Adding to assets while competitors are reducing** capital tied up in assets.

Concealed Liabilities and Expenses

- Understating liabilities and expenses is one of the ways financial statements can be manipulated to make a company appear more profitable than it actually is.
- 3 common methods of concealing liabilities and expenses:
 - Liability / expense omissions
 - Capitalized expenses
 - Failure to disclose warranty costs and liabilities
- **Liability/Expense Omissions:**
 - Easiest method is to simply fail to record them.

Concealed Liabilities and Expenses, cont.

- **Capitalized Expenses:**
 - Capitalizing expenses is another way to increase income and assets because capitalized items are depreciated or amortized over a period of years rather than expensed immediately. Resulting in income being overstated in current period and understated in subsequent periods.
- **Returns and Allowances and Warranties:**
 - Improper recording of sales returns and allowances occurs when a company fails to properly record or present the expense associated with sales returns

Concealed Liabilities and Expenses, cont.

- Red Flags:
 - **Recurring negative cash flow** from operations or an inability to generate positive cash flows from operations while reporting earnings and earnings growth.
 - **Allowances for sales returns, warranty claims**, etc., that are **shrinking** in percentage terms or are otherwise out of line with industry peers.
 - **Reducing accounts payable** while competitors are **stretching out payments to vendors**.

Financial Statement Analysis

- Financial Statement Analysis includes the following:
 - Vertical Analysis
 - Horizontal Analysis
 - Ratio Analysis

Vertical / Horizontal Analysis

- Vertical Analysis:
 - Technique for analyzing the relationships between the items on an income statement, balance sheet, or statement of cash flows by expressing components as percentages. Often referred to as “Common Sizing.”
- Horizontal Analysis:
 - Technique for analyzing the percentage change in individual financial statement items form one year to the next.

Balance Sheet			VERTICAL ANALYSIS				HORIZONTAL ANALYSIS	
Assets			Year 1		Year 2		Change	% Change
Current Assets								
	Cash		45,000	14%	15,000	4%	(30,000)	-67%
	Accts Receivable		150,000	45%	200,000	47%	50,000	33%
	Inventory		75,000	23%	150,000	35%	75,000	100%
	Fixed Assets (net)		60,000	18%	60,000	14%	-	0%
Total			330,000	100%	425,000	100%	95,000	29%
Liabilities & Equity								
	Acc'ts Payable		95,000	29%	215,000	51%	120,000	126%
	Long-term Debt		60,000	18%	60,000	14%	-	0%
Stockholder's Equity								
	Common Stock		25,000	8%	25,000	6%	-	0%
	Paid-In Capital		75,000	23%	75,000	18%	-	0%
	Retained Earnings		75,000	23%	50,000	12%	(25,000)	-33%
Total			330,000	100%	425,000	100%	95,000	29%

Vertical / Horizontal Analysis, cont.

Income Statement	Year 1		Year 2		Change	% Change
Net Sales	250,000	100%	450,000	100%	200,000	80%
Cost of Goods Sold	125,000	50%	300,000	67%	175,000	140%
Gross Margin	125,000	50%	150,000	33%	25,000	20%
Operating Expenses						
Selling Expenses	50,000	20%	75,000	17%	25,000	50%
Administrative Expenses	60,000	24%	100,000	22%	40,000	67%
Net Income	15,000	6%	(25,000)	-6%	(40,000)	-267%

Ratio Analysis

- Ratio Analysis is a means of measuring the relationship between two different financial statement amounts. The relationship and comparison are key to this analysis.
- Common Financial Ratios:
 - Current Ratio
 - Quick Ratio
 - Receivable Turnover
 - Inventory Turnover
 - Debt to Equity Ratio
 - Asset Turnover

Tax Return Review

- Tax Returns are a good source of additional comparative information on the operation of the business.
- A complete review and comparison of financial statements may provide information to lender, or disclose unexplained discrepancies.
- Red Flags:
 - Lack of properly prepared or timely filed tax returns may be a method of stalling or not providing required information.
 - Year after year extensions and filing of tax returns could be a ploy to cover up financial statement and tax return differences.

Case Examples

- Bonneville Pacific
- AFCO Enterprises