# FINANCIAL STATEMENT FRAUD: REVENUE AND RECEIVABLES

Overstating revenue is the most common of all financial statement fraud schemes. As a result, Statement on Auditing Standards (SAS) 99, *Consideration of Fraud in a Financial Statement Audit,* includes a presumption that improper revenue recognition is a fraud risk. According to the 1999 report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the recording of fictitious revenues was the most common revenue fraud, followed by premature recognition of revenues. More broadly speaking, many fraudulent financial-reporting schemes involve earnings management, which the U.S. Securities and Exchange Commission (SEC) has defined as "the use of various forms of gimmickry to distort a company's true financial performance in order to achieve a desired result."

Earnings management does not always involve outright violations of generally accepted accounting principles (GAAP). Companies often manage earnings by choosing accounting policies that bend GAAP to attain earnings targets. There is a difference between aggressive earnings management techniques that GAAP permits and those that clearly violate GAAP. At the same time, it should be noted that the SEC has cautioned that compliance with GAAP is not a protection against an enforcement action if financial performance is distorted.

There are many aspects of GAAP that require management to make a judgment, which makes the application of GAAP more an art than a science. As a simple example, GAAP allows any depreciation method so long as it systematically and rationally allocates the cost of an asset over its useful life. GAAP also allows various methods of inventory valuation, including last in, first out; first in, first out; and specific identification. Other instances in which management must make judgments include:

- Changing depreciation methods from an accelerated method to the more conservative, straight-line method or vice versa
- Changing the useful lives or estimates of the salvage value of assets
- Determining the appropriate allowance required for uncollectible accounts receivable
- Determining whether and when assets have become impaired and are required to be reserved against or written off
- Determining whether a decline in the market value of an investment is temporary or permanent
- Estimating the write-downs required for investments

It is not unfair to say that GAAP allows a company to manage earnings within certain boundaries of integrity through applying their judgment to the application of accounting principles. The SEC has noted that accounting principles are not meant to be straitjackets, and a degree of accounting flexibility is essential to innovation. As former SEC chairman Arthur Levitt noted in 1998, accounting and reporting abuses occur only when this flexibility is exploited to distort the true picture of the corporation.

Companies have a host of reasons for exercising their judgment in applying those principles that will paint the rosiest financial picture, but typically, the most powerful reason is that the market is looking for positive results. That expectation is reflected in the stock price punishment often endured by companies if their reported earnings fall short of estimates, sometimes even by a penny. Yet market pressure to meet earnings estimates is in direct conflict with market pressure for transparency in financial reporting.

It can be a difficult challenge for auditors to distinguish between aggressive but allowable accounting and accounting that is abusive and prohibited. The key determinant is management's intent. Fraud rarely occurs if management's intent is transparent and clearly understandable, but what if management selects a policy it knows will have both a positive and a negative effect on the financial picture—and refuses to recognize the negative effect? Does that demonstrate fraud in the selection of the policy? A difficult question, to be sure. Auditors who encounter such a situation in actual practice may counsel with others and gather facts before drawing any conclusions.

Beyond those areas of legitimate managerial judgments lie frauds that are clearly outside the parameters of GAAP. These techniques may inflate earnings, create an improved financial picture, or mask a deteriorating trend.

***Financial statement fraud is based on deceptively altering the accounting records of a company so as to improperly reflect one or more of the records' basic elements: assets, liabilities and equity, revenues, and expenses.*** In many schemes, the requirements of double-entry bookkeeping result in two or more of these basic categories' being misstated. Some frauds, such as recognition of inventory but not the payable for it, are based on one-sided accounting entries, often accomplished through a subsidiary ledger or record that is incompletely reconciled to the general ledger. The fraud schemes that are the focuses of this chapter—revenue and receivable schemes—are generally accomplished by increasing both revenue and receivable accounts.

**Improper Revenue Recognition**

Improper recognition can take two forms:

i. either premature recognition of revenue generated through legitimate means; or
ii. recognition of fictitious revenue from false sales or to false customers

Overstated revenue can come about by means of:

- Accelerating shipments or holding the books open for sales made subsequent to the end of the accounting period
- Recognizing revenue for transactions that do not actually qualify as sales, such as consignment sales not yet sold to the end user, sales with special conditions, certain bill-and-hold transactions, products shipped for trial or evaluation purposes

- Executing sham sales transacted for the purpose of increasing sales volume, such as swaps or round-trip trades and related party transactions
- Overstating percentage-of-completion sales
- Failing to reduce gross sales for all appropriate adjustments from gross to net—that is, understatement of returns, allowances or discounts including prompt payment discounts, and product markdowns
- Recording fictitious sales

Inquiries into suspected improper revenue recognition usually begin with a review of revenue recognition policies and customer contracts. The auditor may consider the reasonableness of the company's normal practices and whether the company has done everything necessary to comply with them. For example, if a company customarily obtains a written sale agreement, the absence of a written agreement may be a red flag. The review may begin with a detailed reading of the contract terms and provisions. Particular attention may be focused on terms governing payment and shipment, delivery and acceptance, risk of loss, terms requiring future performance on the part of the seller before payment, payment of upfront fees, and other contingencies. A review for these issues as well as others is designed to focus on the general requirements for revenue recognition set forth in GAAP.

TIMING

The auditor may also consider timing, particularly as it relates to the company's quarterly and year-end periods. In which periods were the sales agreements obtained? When was the product or equipment delivered? When did the buyer become obligated to pay? What additional services were required of the seller?

As these questions suggest, the timing of transactions can be manipulated to accelerate revenue recognition. When the timing of recognition is manipulated, the offending company may be facing:

- Pressure to meet revenue targets as the accounting period—that is, the quarter—comes to a close;
- A known or expected shortfall of sales transactions actually consummated through period end;
- The potential existence of sales that are expected to be consummated shortly after period end
- Opportunity either unilaterally or in collusion with customers—that is, counterparties—to alter the dating of these post-period end transactions in order to make such transactions appear to have been consummated prior to the period-end close of business.

Red flags (warning signals) in this area may include:

i. Falsification or alteration of documents, including backdating of delivery or shipping documents;

ii. Backdating or alteration of the dates of invoices;
iii. Alteration or falsification of other dating evidence that might reveal the true date(s) – post-period end—of the arrangement or of delivery of the products sold or services rendered.

A necessary result of any timing irregularity in accounting is that the current accounting period "borrows" revenues from the next period or periods, thus starting off these subsequent periods in the hole. If the next periods also have flat or declining actual sales—thereby exacerbating the revenue shortfall already created by the timing irregularity—even more premature revenue recognition accounting irregularities will be needed at the affected period ends to: Make up the shortfall caused by "lending" revenues to the prior period; Cover the effects of any real decline in sales; and Achieve the expected level of sales growth.

At a time when real sales are declining and such timing irregularity accounting is taking place, each period may require more and more fraudulent premature revenue recognition in order to keep up the appearance—and the fiction—that revenues are growing.

**Revenue Recognition Detection Techniques**

Auditors have a variety of detection tools and techniques to use in the revenue recognition area, ranging from inquiry of relevant managers and substantive analytical tests of account balances to calling in forensic accounting investigators to investigate suspected improprieties. General detection techniques specific to revenue recognition may include the following:

**i.** Discuss with both sales and marketing and financial personnel whether, how, and during which time period revenue targets were achieved; discuss, as well, sales that occurred near the end of the accounting period.
**ii.** Perform cut-off testing to determine whether sales were accelerated or decelerated:
- Examine purchase orders, invoices, and shipping documents.
- Compare shipping volumes with volumes billed.
- Examine ending inventory.
- Look for document pre- or postdating.
- Make inquiries of employees in the shipping area; topics may include large shipments near period end, large returns, bill-and-hold transactions, and the like.

**iii.** Analyse large sales transactions, especially those occurring:
- Near the end of the accounting period
- With a new customer
- With a related party

**iv.** Physically observe goods being shipped.
**v.** Analyse new customers making large purchases:
- Confirm physical location (rather than a post office box).
- Consider comparing entity address with employee addresses.

- Consider confirming existence through public records search.
- Review post-closing transactions for evidence of invoicing and payment of invoice or, alternatively, cancellations or returns.

**vi.** Look for unrecorded and unprocessed returns, whether physically returned or shipped to an off-site warehouse, and those the company has made a commitment to accept.

**vii.** Inquire about side agreements—such as return rights, cancellation provisions, and other guarantees—and inquire of those outside the financial or accounting function as well as of large customers or customers placing so-called purchases late in the reporting period.

**viii.** Analyse sales returns or contract cancellations recorded subsequent to the end of the period.

**ix.** Send confirmations to customers covering quantities, dollar amounts, dates, and side agreements.

- Consider oral confirmations in addition to written confirmations.
- Follow up on unreturned confirmations or confirmations returned with discrepancies

**x.** Review non-system-generated—that is, manual—sales journal entries.

**xi.** Independently verify estimates for percentage of completion.

**xii.** Identify customers or employees and other related parties that are also vendors, and analyze transactions with those entities.

**xiii.** Perform analytical procedures on relationships with sales, including disaggregated sales data.

The auditor may consider substantive testing as a starting point and comb through materials to see if evidence supports the existence of a fraudulent scheme—for example, by requesting and reviewing contracts and support for invoices and deliveries and going on to confirm with customers the existence of accounts receivable and the amount of consigned goods. The auditor may also consider examining public records, when available, and performing background checks on or making site visits to customers, vendors, and other third parties to verify their existence.

In examining specific accounts, the auditor may consider supporting documentation, focusing in particular on round-dollar entries at the end of periods. An auditor who finds entries that are accruals may seek supporting evidence for material reversals and confirm the proper timing of the entries. Absent a written agreement, auditors may consider other evidence of transactions, such as purchase orders, shipping documents, and payment records.

When suspicions of improper revenue recognition exist, auditors may turn to forensic accounting techniques to dig more deeply. Those techniques may range from analytical procedures to analysing round-dollar period-end journal entries by means of data mining. A forensic accounting investigator can assist the financial auditor in determining next steps to perform and the advisable sequence of steps.

While the aforementioned procedures focus primarily on the income statement and the sales side of the revenue recognition issue, the statement of financial position side of the equation is an

additional consideration. Overstatement of accounts receivable balances can be due to improper valuation and the booking of fictitious sales. Only the anticipated collectible value of accounts receivable should be reflected on the balance sheet, and receivables should be written down for uncollectible accounts. Additionally, inflating accounts receivable with fictitious entries is a common scheme to overstate an entity's financial condition. Most frequently, when the fictitious receivables are booked, the corresponding credit is to sales. Falsified sales invoices are normally created to support the fictitious sale and receivable, often by creating phantom customers or hiding fake transactions in the records of large legitimate customers with voluminous activity. Because receivables have to be collected, written off, or disguised in some manner, such as re-aging, they are often the small but visible loose thread that unravels a revenue recognition fraud.

**Detection techniques specific to receivables include the following:**

i. Making oral inquiries of customers regarding receivable balances
ii. Researching all discrepancies between the company's records and confirmation replies
iii. Reviewing subsequent collections
iv. Examining credit agency/analyst reports on key customers
v. Researching all discrepancies between the subsidiary accounts receivable ledger and the general ledger
vi. Testing the aging of accounts receivable and, in particular, considering whether accounts can be re-aged
vii. Examining any manual or non-system journal entries affecting the receivables or sales accounts: Journal entries of this type are relatively uncommon means of recording sales.
viii. Investigating consistent or excessive patterns of partial payments, which may indicate kiting
ix. In the case of fictitious accounts receivable, techniques related to identifying fictitious sales would be applicable
x. Performing analytical procedures on receivables
xi. Testing receivables and inventory as a percentage of current assets (the higher the percentage, the higher the risk) and performing other analytical procedures on inventory, including the examination of data on a disaggregated basis.

**Analytical Procedures to Identify or Explore Potential Revenue Red Flags**

Analytical procedures, especially those performed on a disaggregated basis, often are useful audit tools in identifying potential revenue recognition red flags, and they can help the auditor assess fraud risk factors related to revenue recognition. However, analytics and tests are no substitutes for a good understanding of the client's business. Even seasoned auditors have been misled into believing revenue to be appropriate because they did not fully understand the business. A good question for auditors to ask themselves is, "Do this information and the results obtained make sense in light of the client's industry and business?" Comparing the client's performance against competitors' is a good way to start answering that question along the following dimensions depending upon the circumstance:

i. Reviewing balances in revenue-related accounts for unusual changes
ii. Calculating the percentage of sales and receivables to the total balance sheet in the current period, comparing it with prior periods, and inquiring about any unusual changes
iii. Reviewing cash flows to determine if cash collected is in proportion to reported revenues
iv. Reviewing sales activity for the period and noting unusual trends or increases, particularly near the end of the period.

Significant, unusual, or unexplained changes in certain ratios may also signify areas for further pursuit:

- Increases in net profit margin (net income/total sales)
- Increases in gross profit margin (gross profit/net sales)
- Increases in the current ratio (current assets/current liabilities)
- Increases in the quick ratio (cash and receivables and marketable securities/current liabilities)
- Increases in the accounts receivable turnover (net sales/accounts receivable)
- Increases to days sales outstanding (accounts receivable turnover/365)
- Increases in sales return percentages (sales returns/total sales)
- Increase in asset turnover (total sales/average total assets)
- Increases in working capital turnover (sales/average working capital)
- Decreases in accounts receivable allowance as a percentage of accounts receivable (allowance/total accounts receivable)
- Decreases in the bad debt expense or allowance accounts