

**FINANCIAL FRAUD SCHEMES
SEVEN CATEGORIES, 30 TECHNIQUES**

- 1. REVENUE: Recording Revenue Too Soon or of Questionable Quality**
 - a. Recording revenue when future services remain to be provided
 - b. Recording revenue before shipment or before the customer's unconditional acceptance
 - c. Recording revenue even though the customer is not obligated to pay
 - d. Selling to an affiliated party
 - e. Giving the customer something of value as a quid pro quo
 - f. Grossing up revenue
- 2. REVENUE: Recording Bogus Revenue**
 - a. Recording sales that lack economic substance
 - b. Recording cash received in lending transactions as revenue
 - c. Recording investment income as revenue
 - d. Recording as revenue supplier rebates tied to future required purchases
 - e. Releasing revenue that was improperly held back before a merger
- 3. BOOSTING INCOME WITH ONE-TIME GAINS**
 - a. Boosting profits by selling undervalued assets
 - b. Including investment income or gains as part of revenue
 - c. Reporting investment income or gains as a reduction in operating expenses
 - d. Creating income by reclassification of balance sheet accounts
- 4. SHIFTING CURRENT EXPENSES TO A LATER OR EARLIER PERIOD**
 - a. Capitalizing normal operating costs, particularly if the company recently changed from expensing it
 - b. Changing accounting policies and shifting current expenses to an earlier period
 - c. Amortizing costs too slowly
 - d. Failing to write down or write off impaired assets
 - e. Reducing asset reserves
- 5. FAILING TO RECORD OR IMPROPERLY REDUCING LIABILITIES**
 - a. Failing to record expenses and related liabilities when future obligations remain
 - b. Reducing liabilities by changing accounting assumptions
 - c. Releasing questionable reserves into income
 - d. Creating sham rebates
 - e. Recording revenue when cash is received, even though future obligations remain
- 6. SHIFTING CURRENT REVENUE TO A LATER PERIOD**
 - a. Creating reserves and releasing them into income in a later period
 - b. Improperly holding back revenue just before an acquisition closes
- 7. SHIFTING FUTURE EXPENSES TO THE CURRENT PERIOD AS A SPECIAL CHARGE**
 - a. Improperly inflating the amount included in a special charge
 - b. Improperly writing off in-process R&D costs from an acquisition
 - c. Accelerating discretionary expenses into the current period

ETHICAL GUIDING PRINCIPLES

- 1) Revenue should be recorded after the earnings process has been completed and an exchange has occurred. Similarly gains should be recorded when there is an exchange.
- 2) An enterprise should capitalize costs incurred that produce a future benefit, and expense those that produce no such benefit.
- 3) As an enterprise realizes the benefits from using an asset, the asset or a part thereof should be written off as an expense of the period.
- 4) When there is a sudden and substantial impairment in an assets value, the asset should be written off immediately in its entirety, rather than gradually over time.
- 5) An enterprise has incurred a liability if it is obligated to make future sacrifices.
- 6) Revenue should be recorded in the period in which it is earned. If service is provided in the current period, it is improper to report the revenue in a later period.
- 7) Expenses should be charged against income in the period in which the benefit is received.
- 8) Investors should be alert for one-time gains or income from noncore activities that camouflage a company's deteriorating core business (however, such one-time gains accruing to an otherwise healthy business should be of little concern).

Appendix. Comprehensive Checklist of Warning Signs

Balance Sheet and Statement of Operations

Warning Sign	Problem Indicated or Shenanigan Used
1. Cash and equivalents decline relative to total assets	Liquidity issues; may need to borrow
2. Receivables grow substantially faster than sales	Perhaps aggressive revenue recognition—recording revenue too soon or granting extended credit terms to customers
3. Receivables grow substantially slower than sales	Receivables may have been reclassified as another asset category
4. Bad debt reserves decline relative to gross receivables	Underreserving and inflating operating income
5. Unbilled receivables grow faster than sales or billed receivables	A greater portion of revenue may be coming from sales under the percentage-of-completion method
6. Inventory grows substantially faster than sales, cost of sales, or accounts payable	Inventory may be obsolete, requiring a write-off; company may have failed to charge the cost of sales on some sales
7. Inventory reserves decline relative to inventory	Underreserving and inflating operating income
8. Prepaid expenses shoot up relative to total assets	Perhaps improperly capitalizing certain operating expenses
9. Other assets rise relative to total assets	Perhaps improperly capitalizing certain operating expenses
10. Gross plant and equipment increases sharply relative to total assets	Perhaps capitalizing maintenance and repair expense
11. Gross plant and equipment declines sharply relative to total assets	Failing to invest in new plant and equipment

Warning Sign	Problem Indicated or Shenanigan Used
12. Accumulated depreciation declines as gross plant and equipment rises	Failing to take sufficient depreciation charge—inflating operating income
13. Goodwill rises sharply relative to total assets	Perhaps tangible assets were reclassified to goodwill to avoid expensing them in future periods
14. Accumulated amortization declines as goodwill rises	Failing to take sufficient amortization charge—inflating operating income
15. Growth in accounts payable substantially exceeds revenue growth	Failed to pay off current debts for inventory and supplies—will require larger cash outflow in future period
16. Accrued expenses decline relative to total assets	Perhaps company released reserves—inflating operating income
17. Deferred revenue declines while revenue increases	Either new business is slowing or company released some reserves to inflate revenue
18. Cost of goods sold grows rapidly relative to sales	Pricing pressure results in lower gross margins
19. Cost of goods sold declines relative to sales	Company may have failed to transfer the entire cost of the product from inventory
20. Cost of goods sold fluctuates widely from quarter to quarter relative to sales	Unstable gross margin could indicate accounting irregularities
21. Operating expenses decline sharply relative to sales	Perhaps improperly capitalizing certain operating expenses
22. Operating expenses rise significantly relative to sales	Company may have become less efficient, spending more for each unit sold
23. Major portion of pretax income comes from one-time gains	Core business may be weakening

Balance Sheet and Statement of Operations (Continued)

Warning Sign	Problem Indicated or Shenanigan Used
24. Interest expense rises materially relative to long-term debt	Higher cash outflow expected
25. Interest expense declines materially relative to long-term debt	Perhaps improperly capitalizing certain operating expenses
26. Amortization of software costs grows more slowly than capitalized costs	Perhaps improperly capitalizing certain operating expenses

Statement of Cash Flows

Warning Sign	Problem Indicated or Shenanigan Used
1. CFFO materially lags behind net income	Quality of earnings may be suspect or expenditures for working capital may have been too high
2. Company fails to disclose details of cash flow from operations	Company may be trying to hide the source of the operating cash problem
3. Cash inflows come primarily from asset sales, borrowing, or equity offerings	Signs of weakness, especially if cash comes exclusively from asset sales, borrowing, or equity offerings

Narrative: Footnotes, Management Discussion, Proxy, Auditor's Letter

Warning Sign	Problem Indicated or Shenanigan Used
1. Change in accounting principle	Attempt to hide an operating problem
2. Change in accounting estimate	Attempt to hide an operating problem
3. Change in accounting classification	Attempt to hide an operating problem
4. Change in auditor	Sign of risky client
5. Change in CFO or outside counsel	Sign of risky client
6. Investigation by the SEC	Could lead to accounting restatements

Warning Sign	Problem Indicated or Shenanigan Used
7. Long-term commitments/contingencies	Potentially large drain on cash reserves
8. Current or potential litigation	Potentially large drain on cash reserves
9. Liberal accounting policies	Financial reports may inflate profits
10. Misguided management incentives	May lead to some financial shenanigans to boost profits, bonuses, and share price
11. Weak control environment	Creates easy opportunities to perpetrate financial shenanigans
12. Auditor's concern	Sign of risky client
13. Promotional management	May be more likely to use financial shenanigans than more modest executives
14. Use of percentage of completion accounting	Revenue may be inflated
15. Use of bill and hold accounting	Potential business problem if one of them leaves
16. Overreliance on a few customers	Business can be hurt if a key customer files for bankruptcy
17. Financial problems at key customer	Revenue may be inflated and business may be much weaker than you realized
18. Seller finances customer	Revenue may have been recorded too soon
19. Customer has right of return	Revenue may have been inflated
20. Barter transaction	Revenue may have been inflated
21. Seller gives customer stock warrants	Operating income may be inflated
22. Capitalized interest or software	Future cash obligations may be greater than expected and operating income may be inflated
23. Unrecorded liabilities, such as stock options	

Narrative: Footnotes, Management Discussion, Proxy, Auditor's Letter (Continued)

Warning Sign	Problem Indicated or Shenanigan Used
24. Noncompliance with debt covenant	Bank may call loan, causing a substantial cash crunch
25. Absence of unaffiliated directors on board	Weak control environment may create opportunities for management to perpetrate financial shenanigans
26. Prepayment of future periods' operating expenses	Leads to inflated operating income in future periods

Checklist 1: Possible Signs of Misleading Financial Statements

Choosing accounting policies	Too liberal
Changing accounting policies	Unjustified
Deferring expenses	Profits are overstated
Income smoothing	Profits are understated
Recognizing revenue too soon	Profits are overstated
Underaccruing expenses	Manipulating profits
Changing discretionary costs	Risk of shenanigans
Low quality controls	Risk of shenanigans
Changing auditor	Future profits are boosted
Taking a "big bath"	