

Learning Objectives

1. Identify revenue-related financial statement fraud schemes.
2. List ways to search for symptoms of revenue-related financial statement fraud.
3. Understand the importance of, and ways to follow up on, revenue-related fraud symptoms.
4. Discuss inventory-related financial statement fraud schemes.
5. Identify ways to search for inventory-related financial statement fraud symptoms.
6. Explain the importance of, and ways to follow up on, inventory-related fraud symptoms.

Revenue-Related Fraud (1 of 5)

- The most common accounts manipulated when perpetrating financial statement fraud are revenues and/or receivables
- Over half of all financial statement frauds involved revenues and/or accounts receivable accounts, according to COSO-sponsored research

Revenue-Related Fraud (2 of 5)

- **Two reasons for the prevalence of revenue-related financial statement fraud:**
 - The availability of acceptable alternatives for recognizing revenue
 - The ease of manipulating net income using revenue and receivable accounts

Revenue-Related Fraud (3 of 5)

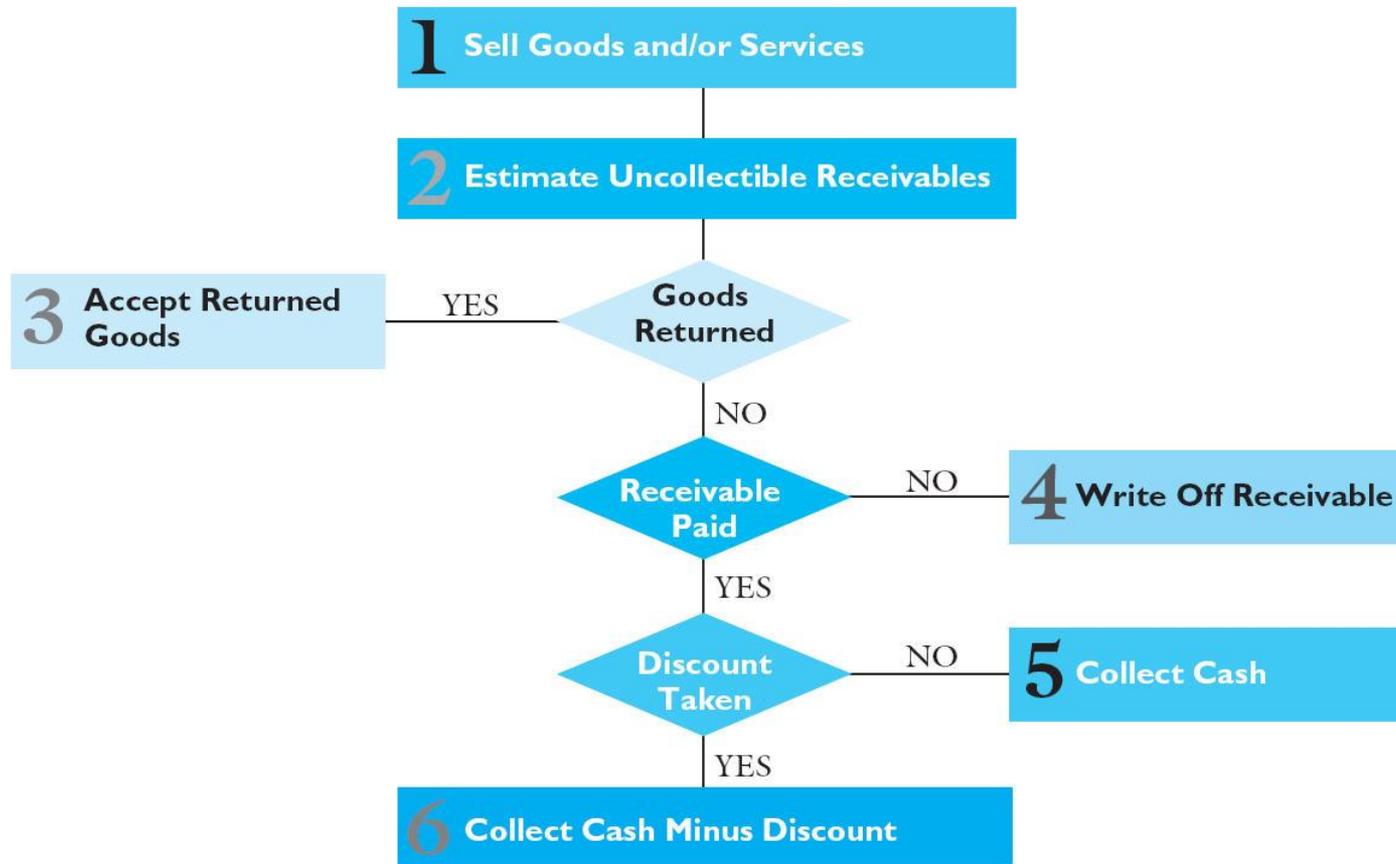
- Revenue-related fraud exposures should be considered in every business
- **Common Revenue-Related Fraud Schemes:**
 - Related-party transactions
 - Sham sales
 - Bill-and-hold sales
 - Side agreements
 - Consignment sales
 - Channel stuffing

Revenue-Related Fraud (4 of 5)

Common Revenue-related Fraud Schemes:

- Lapping or kiting
- Redating or refreshing transactions
- Liberal return policies
- Partial shipment schemes
- Improper cutoff
- Round-tripping

Revenue-Related Fraud (5 of 5)



Identifying Revenue-Related Fraud Symptoms

- Fraud is rarely observed
- Fraud symptoms can be divided into six categories:
 - Analytical symptoms
 - Accounting or documentary symptoms
 - Lifestyle symptoms
 - Control symptoms
 - Behavioral and verbal symptoms
 - Tips and complaints

Identifying Revenue-Related Fraud

(1 of 6)

- **Analytical Symptoms**

- Revenue or sales that appear too high.
- Sales discounts that appear too low.
- Sales returns that appear too low.
- Bad debt expense that appears too low.
- Accounts receivable that appear too high or are increasing too fast.
- The allowance for doubtful accounts appears too low.
- Too little cash is collected relative to reported revenues.

Identifying Revenue-Related Fraud (2 of 6)

- **Accounting or Documentary Symptoms**
 - Unsupported or unauthorized revenue-related balances or transactions.
 - Missing documents in the revenue cycle.
 - Photocopies where original should exist.
 - Significant unexplained items on bank and other reconciliations.
 - Revenue-related ledgers (sales, cash receipts, etc.) that do not balance.

Identifying Revenue-Related Fraud (3 of 6)

- **Control Symptoms**

- Management override of significant internal control activities related to the revenue cycle.
- New, unusual, or large customers that appear not to have gone through the customer approval process.
- Weaknesses in the cutoff processes or other key accounting processes.

Identifying Revenue-Related Fraud (4 of 6)

- **Behavioral and Verbal Symptoms**
 - Inconsistent, vague, or implausible responses from management or employees arising from revenue inquiries or analytical procedures.
 - Denied access to facilities, employees, records, customers, vendors, or others from whom revenue-related audit evidence might be sought.
 - Undue time pressures imposed by management to resolve contentious or complex revenue-related issues.

Identifying Revenue-Related Fraud (5 of 6)

- **Lifestyle Symptoms**

- Major sales of company stock around earnings releases or other unusual dates.
- Significant bonuses tied to meeting earnings forecasts.
- Executives' personal net worth tied up in company stock.

Identifying Revenue-Related Fraud (6 of 6)

- **Tips and Complaints**

- Tips or complaints that revenue-related fraud might be occurring, either from the company whistleblower system or in other ways.
- Revenue frauds disclosed at companies with which this company does significant business.

Inventory & Cost of Goods Sold Frauds (1 of 10)

INCOME STATEMENT	WHEN INVENTORY IS OVERSTATED, THEN
Gross Revenues (Sales)	Are not affected
- Sales Returns	Are not affected
- Sales Discounts	Are not affected
= Net Revenues (Sales)	Are not affected
- Cost of Goods Sold	Is understated
= Gross Margin	Is understated
- Expenses	Are not affected
= Net Income	Is overstated

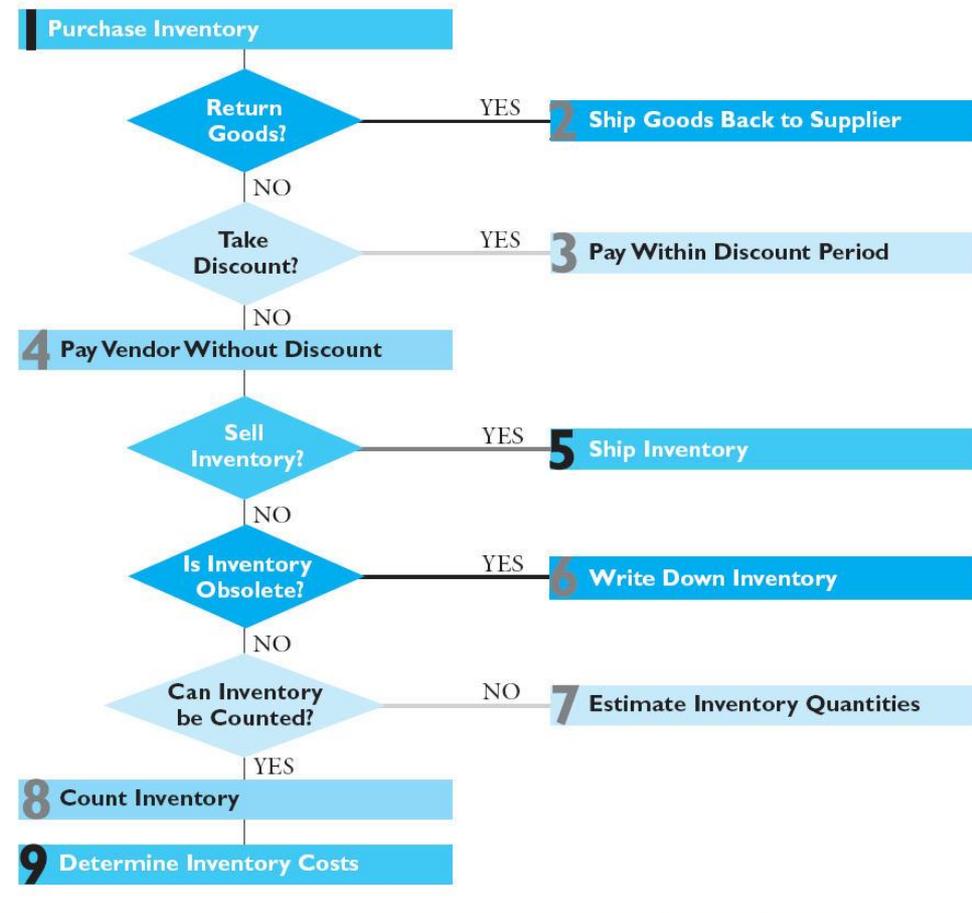
Inventory & Cost of Goods Sold Frauds (2 of 10)

COST OF GOODS SOLD CALCULATION	PERIOD 1, OVERSTATEMENT OF ENDING INVENTORY	PERIOD 2
Beginning Inventory	Not affected	Overstated
+ Purchases of Inventory	Not affected	Not affected
- Returns of Inventory to Vendor	Not affected	Not affected
- Purchase Discounts on Inventory Purchases	Not affected	Not affected
= Goods Available for Sale	Not affected	Overstated
- Ending Inventory	Overstated	Not affected
= Cost of Goods Sold	Understated	Overstated

Inventory & Cost of Goods Sold Frauds (3 of 10)

- **Most common inventory-related fraud schemes:**
 - Double counting
 - Capitalizing
 - Cutoff problems
 - Overestimating inventory
 - Bill-and-hold sales
 - Consigned inventory

Inventory & Cost of Goods Sold Frauds (4 of 10)



Inventory & Cost of Goods Sold Frauds

(5 of 10)

- Analytical Symptoms
 - Reported inventory balances that appear too high or are increasing too fast.
 - Reported cost of goods sold balances that appear too low or are decreasing too fast.
 - Reported purchase returns that appear too high or are increasing too rapidly.
 - Reported purchase discounts that appear too high or are increasing too rapidly.
 - Reported purchases that appear too low for sales or inventory levels.
 - Capitalized inventory that looks as if it should be expensed.

Inventory & Cost of Goods Sold Frauds

(6 of 10)

- Accounting or Documentary Symptoms
 - Inventory or cost of goods sold transactions that are not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or entity.
 - Unsupported or unauthorized inventory or cost of goods sold-related transactions.
 - End-of-period inventory or cost of goods sold adjustments that significantly change the entity's financial results.
 - Missing documents related to inventory and/or cost of goods sold.

Inventory & Cost of Goods Sold Frauds (7 of 10)

- Control Symptoms
 - Management override of significant internal control activities related to purchases, inventory, or cost of goods sold.
 - New or unusual vendors that appear not to have gone through the regular vendor-approval process.
 - Weaknesses in the inventory counting process.

Inventory & Cost of Goods Sold Frauds (8 of 10)

- Behavioral and Verbal Symptoms
 - Inconsistent, vague, or implausible responses from management or employees arising from inventory, purchase, or cost of goods sold-related inquiries or analytical procedures.
 - Undue time pressures imposed by management to resolve contentious or complex inventory or cost of goods sold-related issues.
 - Unusual delays by the entity in providing requested inventory or cost of goods sold-related information.

Inventory & Cost of Goods Sold Frauds (9 of 10)

- Lifestyle Symptoms
 - Similar symptoms to the revenue-related frauds (e.g., stock sales, bonuses, and stock ownership). However, lifestyle symptoms are often not very diagnostic of financial statement fraud.
- Tips and Complaints
 - Tips or complaints generated through the whistle-blowing system or through other means may suggest that inventory-related fraud schemes might be occurring.

Inventory & Cost of Goods Sold Frauds (10 of 10)

- Analyzing financial statements for inventory fraud

Analyzing financial balances and relationships within financial statements	Look for unusual changes in inventory and cost of goods sold account balances from period to period	Look for unusual changes in inventory and cost of goods sold relationships from period to period
Comparing financial statement amounts or relationships with other information	Compare financial results and trends of the company with those of similar firms in the same industry	Compare recorded amounts in the financial statements with nonfinancial statement amounts

Analyzing Financial Statements

STOP & THINK *What are some potentially legitimate reasons for a company to have high inventory balances?*
