

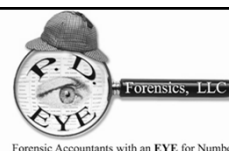
Catching the Snake: Financial Statement Fraud & Other Red Flags



**Buckeye Financial Forum
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P.D. Eye Forensics, LLC**

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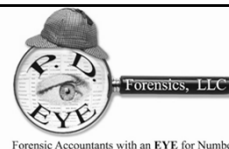


Learning Objectives

- ❖ **Financial Statement Fraud**
 - ❖ Relationship Between an Audit & Fraud
 - ❖ Fraud Schemes and Examples
 - ❖ Warning Signs
 - ❖ Detection Techniques
- ❖ **Other Common Fraud Areas**
 - ❖ Cash Disbursements
 - ❖ Cash Receipts

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Snake: aka Perpetrator



❖ Gender – Frequency / Median Loss

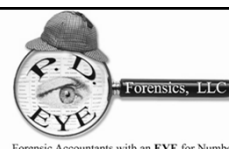
- ❖ Male 69% / \$187,000
- ❖ Female 31% / \$100,000

❖ Tenure – Frequency / Median Loss

- ❖ <1 Year 8.2% / \$ 49,000
- ❖ 1-5 Years 42.4% / \$100,000
- ❖ 6-10 Years 26.5% / \$210,000
- ❖ 10 Years + 22.9% / \$250,000

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Snake: aka Perpetrator (cont'd)



❖ Age – Frequency / Median Loss

- ❖ 31-35 15.6% / \$100,000
- ❖ 36-40 20.0% / \$100,000
- ❖ 41-45 19.4% / \$250,000
- ❖ 46-50 14.8% / \$250,000
- ❖ 51-55 8.2% / \$280,000
- ❖ 56-60 4.5% / \$258,000
- ❖ > 60 2.5% / \$630,000



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Forensic Accountants with an EYE for Numbers

FINANCIAL STATEMENT FRAUD

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Forensic Accountants with an EYE for Numbers

The Audit Will Catch It – WRONG!

- ❖ Auditors are not at fault for failing to deter fraud but will likely be held responsible for the failure to detect material misstatements in the financials.
- ❖ Deterrence is the responsibility of the organization.

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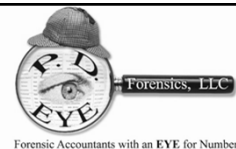
Why Audits Fail to Detect Fraud



- ❖ Auditors look for consistency.
- ❖ Reliance on random samples of transactions.
- ❖ Undue reliance on internal controls.
- ❖ Audit procedures known and too predictable.

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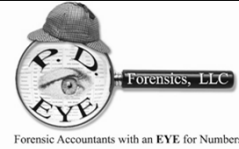
Why Audits Fail to Detect Fraud (cont'd)



- ❖ Crime is usually perceived as an error.
- ❖ Company silence, neither auditor or law enforcement advised of internally discovered schemes.
- ❖ Fee pressures.
- ❖ Lack of auditor fraud training.

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Financial Statement Fraud Schemes & Examples

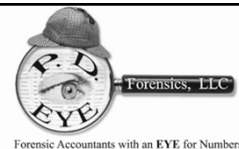


❖ Typical fraud schemes

1. Overstate Assets and/or Revenues
2. Understate Liabilities and/or Expenses

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FS Fraud Schemes & Examples (cont'd)

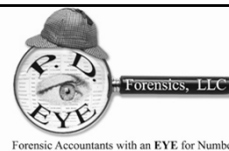


❖ Fictitious Revenues

- Prepare a fictitious invoice for goods or services not delivered
- Example: Record fictitious purchase of fixed assets and sale of goods for same amount.

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FS Fraud Schemes & Examples (cont'd)

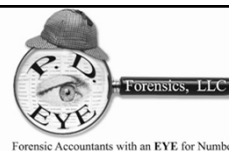


Entry #	Date	Description	Debit	Credit
1	12/1/10	Fixed Assets	350,000	
		Cash		350,000
2	12/1/10	A/R	350,000	
		Sales		350,000
3	12/15/10	Cash	350,000	
		A/R		350,000

- ❖ The result is an increase in both fixed assets and revenue

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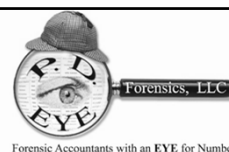
FS Fraud Schemes & Examples (cont'd)



- ❖ **Timing Differences**
 - ❖ The recording of revenue and/or expenses in improper periods

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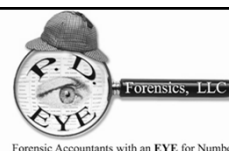
FS Fraud Schemes & Examples (cont'd)



- ❖ Accounts receivable
 - ❖ Booking fictitious accounts receivable
 - ❖ Not writing off bad debt
- ❖ Inventory
 - ❖ Failing to write down inventory (obsolete)
 - ❖ Manipulating physical inventory count
- ❖ Fixed Assets
 - ❖ Recording fictitious assets
 - ❖ Misrepresenting value of fixed assets

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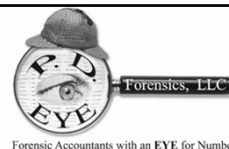
FS Fraud Schemes & Examples (cont'd)



- ❖ Liabilities
 - ❖ Failing to record liabilities on balance sheet
 - ❖ Failure to disclose warranty costs & liabilities
 - ❖ Liability omissions (i.e. loan covenants)
 - ❖ Subsequent events
 - ❖ Management fraud
 - ❖ Related Party Transactions
 - ❖ Accounting changes

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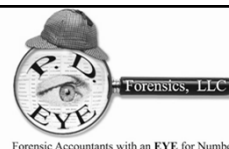
Warning Signs of Fraudulent Financial Statements



- ❖ Changes in auditors or a history of changing auditors
- ❖ Audit of books refused
- ❖ Long delays in releasing financial statements
- ❖ Refusal by owner to provide personal guarantee
- ❖ Cash flow problems
- ❖ Excessive debts

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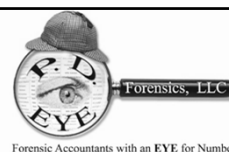
Warning Signs of Fraudulent FS (cont'd)



- ❖ Restrictive loan covenants:
 - ❖ Working capital requirements
 - ❖ Retained earnings & equity restrictions
 - ❖ Stringent profit goals
- ❖ Immediate need to show impressive or profitable financial statement
- ❖ Large increase in inventory without increased sales

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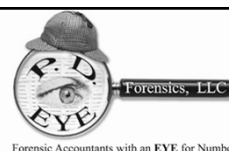
Warning Signs of Fraudulent FS (cont'd)



- ❖ Rapid expansion without corresponding increase in sales & profit
- ❖ Industry experiencing problems but no indication of problems with the company
- ❖ Constant overdraft of cash accounts
- ❖ Unpaid payroll tax deposits
- ❖ Accounts receivable growing faster than sales

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Fraud Detection Key Fact



- ❖ Management fraud resides on the balance sheet
- ❖ Employee fraud runs through the income statement

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Detection Techniques

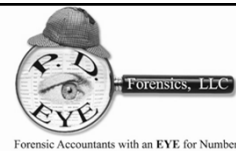


❖ Percentage Analysis

- ❖ Vertical
- ❖ Horizontal

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Detection Techniques (cont'd)

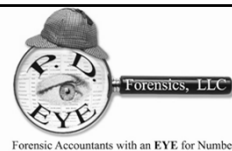


❖ Ratio Analysis

- ❖ Current ratio
- ❖ Quick ratio
- ❖ Receivable turnover
- ❖ Collection ratio
- ❖ Inventory turnover

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Detection Techniques (cont'd)

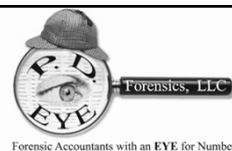


❖ Ratio Analysis (cont'd)

- ❖ Days inventory in stock
- ❖ Debt to equity ratio
- ❖ Gross margin
- ❖ Profit margin
- ❖ Asset turnover

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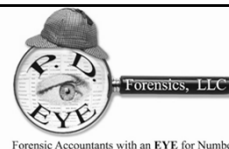
Detection Techniques (cont'd)



- ❖ Cash flow from operations less net income
- ❖ Perform analysis over a sufficient period of time (five to ten years)
- ❖ Analyze profit and sales on a monthly basis, be alert to end of period activity spikes

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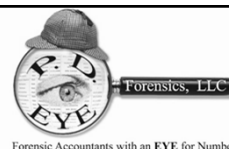
Detection Techniques (cont'd)



- ❖ Analyze tax returns and compare to financial statements
- ❖ Data mining
 - ❖ Ghost employees
 - ❖ Ghost vendors
 - ❖ Fake sales and locations

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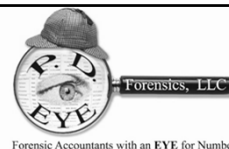
Detection Techniques (cont'd)



Do the results of analysis make sense when company is compared to others in industry and the overall economy?

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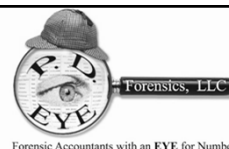
Common Areas Where Fraud Occurs



- ❖ Cash disbursements
- ❖ Cash receipts
- ❖ Inventory theft
- ❖ Payroll schemes
- ❖ Billing schemes
- ❖ Corruption

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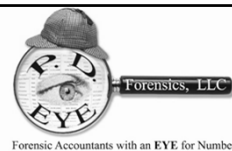
Minimizing Fraud Exposure: Disbursements



- ❖ Lock up check stock and signature stamps.
- ❖ Use positive pay or reverse positive pay.
- ❖ Online Information Reporting Platform
- ❖ Consolidate payables which allows multiple payment methods.

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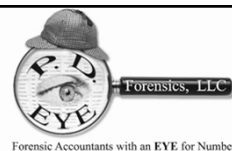
Minimizing Fraud Exposure: Disbursements (cont'd)



- ❖ Utilize EPA to authorize ACH disbursements.
- ❖ Payroll Cards.
- ❖ Purchase Cards (P-Cards).
- ❖ Put procedures in place for wire transfers

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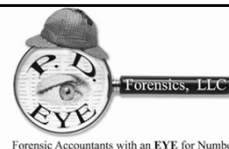
Minimizing Fraud Exposure: Receipts



- ❖ UPIC to receive payments via ACH.
- ❖ Lock box to receive payments.
- ❖ Deposit Tracking from your locations.

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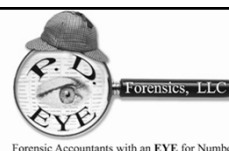
Educating Your Business Clients



- ❖ Share the fraud statistics with them.
 - ❖ Communicate via articles, presentations, year end engagements, etc.
- ❖ Make them aware of the warning signs of fraud.
- ❖ Share the "10 Steps to Deter Fraud."
- ❖ Advise them on proper response to suspicions of fraud, waste and abuse.

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Recovery of Losses in Occupational Fraud Cases



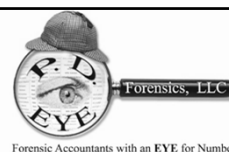
In **49%** of all occupational fraud cases, the victim recovered

NOTHING

in the amount stolen by the perpetrator.

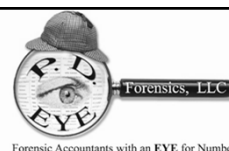


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QUESTIONS?

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