Financial Transactions and Fraud Schemes

Accounting Concepts
Accounting Basics

Assets = Liabilities + Owners’ Equity
Accounting Basics

- By definition, the *Assets* side of the equation consists of the net resources owned by an entity.
- *Liabilities* are the obligations of an entity or an outsider’s claim against a company’s assets.
- *Owners’ Equity* represents the investment of the owners in the company plus accumulated profits (revenues less expenses).
Accounts and the Accounting Cycle

- Entries to the left side of an account are *debits* (dr), and entries to the right side of an account are *credits* (cr).
- Debits increase asset and expense accounts, while credits decrease them.
- Conversely, credits increase liability, owners’ equity, and revenue accounts; debits decrease them.
- Every transaction recorded in the accounting records will have both a debit and a credit, thus the term *double-entry accounting*.
Balance Sheet

- The *balance sheet* shows a “snapshot” of a company’s financial situation at a specific point in time, generally the last day of the accounting period.
- It is an expansion of the accounting equation, \( assets = liabilities + owners’ \text{ equity} \).
# Balance Sheet

**XYZ Company**  
**Balance Sheet**  
**December 31, 20XX**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td></td>
<td><strong>Current Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 148,000</td>
<td>Accounts Payable</td>
<td>$ 11,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>75,000</td>
<td>Total Current Liabilities</td>
<td>$ 11,000</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>$ 223,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fixed Assets</strong></td>
<td></td>
<td><strong>Long-term Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>200,000</td>
<td>Notes Payable</td>
<td>75,000</td>
</tr>
<tr>
<td>Less: Accum. Depr.</td>
<td>(137,000)</td>
<td>Total Long-term Liabilities</td>
<td>75,000</td>
</tr>
<tr>
<td>Total Fixed Assets</td>
<td>63,000</td>
<td>Total Liabilities</td>
<td>86,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$ 286,000</td>
<td><strong>Owners’ Equity</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Common Stock</td>
<td>102,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Retained Earnings</td>
<td>98,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total Owners’ Equity</td>
<td>200,000</td>
</tr>
<tr>
<td><strong>Total Liabilities and Equity</strong></td>
<td></td>
<td></td>
<td><strong>Total Liabilities and Equity</strong></td>
</tr>
</tbody>
</table>
Owners’ Equity

- Usually represents amounts from two sources:
  - Common or capital stock and paid-in capital
  - Undistributed earnings (retained earnings)
Financial Statements

Assets = Liabilities + Owners’ Equity

Common Stock

Retained Earnings
Income Statement

- Income statement details how much profit (or loss) a company earned during a period of time, such as a quarter or a year.

- The accounts reflected on the income statement are temporary; at the end of each fiscal year, they are reduced to a zero balance (closed), with the resulting net income (or loss) added to (or subtracted from) retained earnings on the balance sheet.
# Financial Statements

**XYZ Company**  
**Income Statement**  
**For the Year Ended December 31, 20XX**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
</tr>
<tr>
<td>Net Sales</td>
<td>$ 400,000</td>
</tr>
<tr>
<td>Less: Cost of Goods</td>
<td>250,000</td>
</tr>
<tr>
<td>Sold</td>
<td></td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>$ 150,000</td>
</tr>
<tr>
<td><strong>Operating Expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Payroll</td>
<td>77,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>4,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>19,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>15,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>27,000</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>142,000</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$ 8,000</td>
</tr>
</tbody>
</table>
Revenue - Expenses = Net Income
Income Statement

- Most companies present *net sales* or *net service revenues* as the first line item on the income statement.
- The difference between net sales and cost of goods sold is called *gross profit* or *gross margin*, which represents the amount left over from sales to pay the company’s operating expenses.
Statement of Changes in Owners’ Equity

- The statement of changes in owners’ equity details the changes in the total owners’ equity amount listed on the balance sheet.
- Because it shows how the amounts on the income statement flow through to the balance sheet, it acts as the connecting link between the two statements.
XYZ Company
Statement of Owners’ Equity
For the Year Ended December 31, 20XX

Owners’ equity, January 1, 20XX $ -
Investment by owners during the year $ 192,000
Net income for the year 8,000
Increase in owners’ equity 200,000
Owners’ equity, December 31, 20XX $ 200,000
Statement of Cash Flows

- The statement of cash flows reports a company’s sources and uses of cash during the accounting period.
- Often used by potential investors and other interested parties in tandem with the income statement to determine a company’s true financial performance.
- The statement of cash flows is broken down into three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities.
# Statement of Cash Flows

**XYZ Company**  
Statement of Cash Flows—Direct Method  
For the Year Ended December 31, 20XX

### Cash flows from operating activities
- Cash received from customers: $15,000
- Cash paid for merchandise: $(14,000)
- Net cash flows from operating activities: $1,000

### Cash flows from investing activities
- Cash paid for purchase of equipment: $(70,000)
- Net cash flows from investing activities: $(70,000)

### Cash flows from financing activities
- Cash received as owners’ investment: $192,000
- Cash received from issuing note payable: $80,000
- Cash paid on note payable: $(5,000)
- Net cash flows from financing activities: $267,000

### Increase in cash
- Increase in cash: $198,000

### Cash balance
- Cash balance at the beginning of the year: 0
- Cash balance at the end of the year: $198,000
Generally Accepted Accounting Principles (GAAP)

- Historical Cost
- Revenue Recognition
- Matching
- Consistency
- Full Disclosure
- Going Concern

- Departures from GAAP:
  - Conservatism
  - Industry Practices
  - Substance over Form
  - Application of Judgment
  - Materiality
  - Cost-Benefit
1. Which of the following represents the correct accounting model?

A. Assets + Liabilities = Owners’ Equity
B. Assets = Liabilities + Owners’ Equity
C. Assets = Liabilities – Owners’ Equity
D. None of the above
Correct Answer: B

- Accounting is based on the model or accounting equation:

  Assets = Liabilities + Owners’ Equity
Sample Prep Question

2. Delta, a Certified Fraud Examiner and expert accounting witness in the United States, was explaining to the jury that a company’s financial statements must include information on changes in accounting methods, contingent liabilities, significant subsequent events, and all other information necessary for users to make valid, informed decisions. Delta was explaining the concept of:

A. Consistency
B. Going concern
C. Full disclosure
D. None of the above
The accounting principle of full disclosure requires an entity’s financial statements to include all information necessary for users to make valid decisions. The statements should not include too much information, but are required to include enough information to refrain from misleading the user. Supplemental notes to the financial statements are often required to meet these criteria.
Sample Prep Question

3. Which of the following could be used to balance the accounting equation if cash were stolen?

A. Increasing another asset
B. Reducing a liability
C. Reducing revenue
D. All of the above
Correct Answer: D

- The accounting equation, Assets = Liabilities + Owners’ Equity, is the basis for all double-entry accounting. If an asset (e.g., cash) is stolen, the equation can be balanced by increasing another asset, reducing a liability, reducing an owners’ equity account, reducing revenues (and thus retained earnings), or creating an expense (and thus reducing retained earnings).
Financial Transactions and Fraud Schemes

Financial Statement Fraud
Financial Statement Fraud

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

- Not always for direct personal financial gain
- To encourage investment through the sale of stock
- To demonstrate increased earnings per share or partnership profits interest, thus allowing increased dividend/distribution payouts
- To cover inability to generate cash flow
- To avoid negative market perceptions
- To obtain financing, or to obtain more favorable terms on existing financing
- To receive higher purchase prices for acquisitions
- To demonstrate compliance with financing covenants
- To meet company goals and objectives
- To receive performance-related bonuses
Typical Financial Statement Fraud Forms

- Overstated Assets or Revenue
- Understated Liabilities and Expenses
Classifications of Financial Statement Schemes

- Fictitious Revenues
- Timing Differences
- Improper Asset Valuations
- Concealed Liabilities and Expenses
- Improper Disclosures
Fictitious Revenues

- Mysterious accounts receivable on the books that are long overdue are a common sign of a fictitious revenue scheme.
Timing Differences

- The recording of revenues and/or expenses in improper periods
- Shifts revenues or expenses between one period and the next, increasing or decreasing earnings as desired
Premature Revenue Recognition

- Revenue is typically recognized when:
  - Persuasive evidence of an arrangement exists
  - Delivery has occurred or services have been rendered
  - The seller’s price to the buyer is fixed or determinable
  - Collectability is reasonably assured

- Sales with conditions

- Long-term contracts
  - Percentage of completion method
Recording Expenses in the Wrong Period

- Often compromised due to pressures to meet budget projections and goals, or due to lack of proper accounting controls
- This might make the sales revenue from the transaction almost pure profit, inflating earnings
- In the next period, earnings would have fallen by a similar amount
- Costs not properly matched
Improper Asset Valuation

- Inventory Valuation
- Accounts Receivable
- Business Combinations
- Fixed Assets
Inventory Valuation

- Inventory should be written down to its current value, or written off altogether if it has no value.
- Failing to write down inventory results in overstated assets and the mismatching of cost of goods sold with revenues.
- Inventory can also be improperly stated through the manipulation of the physical inventory count, inflation of the unit costs used to price out inventory, failure to relieve inventory for costs of goods sold, and by other methods.
- Schemes usually involve the creation of fake documents such as inventory count sheets, receiving reports, and similar items.
Accounts Receivable

- Fictitious Accounts Receivable
  - Common among companies with financial problems
  - Debits accounts receivable and credits sales
  - More common around end of accounting period

- Failure to Account for Uncollectible Accounts
  - Companies generally are required to write off uncollectible receivables as bad debt expense
  - Managers can overstate their company’s accounts receivable balance by failing to record bad debt expense
Concealed Liabilities and Expenses

- Common methods for concealing liabilities and expenses include:
  - Liability/expense omissions
  - Improperly capitalized costs
  - Failure to disclose warranty costs and product-return liabilities
- Understating liabilities and expenses manipulates the company to appear more profitable than it actually is
Improperly Capitalized Costs

- Another way to increase income and assets since capitalized items are depreciated or amortized over a period of years rather than expensed immediately.
- If expenditures are capitalized as assets and not expensed during the current period, income will be overstated.
- Organizations sometimes “expense” capitalized expenses to understate income and avoid taxes.
Improper Disclosures

- Management is obligated to disclose all significant information in the financial statements. Improper disclosures relating to financial statement fraud usually involves the following:
  - Liability omissions
  - Subsequent events
  - Management fraud
  - Related-party transactions
Liability Omissions

- Typically includes the failure to disclose loan covenants or contingent liabilities
  - **Loan covenants** are agreements, in addition to or as part of a financing arrangement, which a borrower has promised to keep as long as the financing is in place
  - **Contingent liabilities** are potential obligations that will materialize only if certain events occur in the future
    - Corporate guarantees of personal liability
    - Liability must be disclosed if material
Subsequent Events

- Events occurring or becoming known after the close of the period could have a significant effect on the entity’s financial statements and must be disclosed.
Management has an obligation to disclose to the shareholders significant fraud committed by officers, executives, and others in a position of trust.

Withholding such information from auditors would likely also involve lying to auditors, an illegal act in itself.
Related-Party Transactions

- Occur when a company does business with another entity whose management or operating policies can be controlled or significantly influenced by the company or by some other party in common.
- Not inherently wrong as long as fully disclosed.
- Often referred to as *self-dealing*.
Accounting Changes

- In general, three types of accounting changes must be disclosed to avoid misleading the user of financial statements:
  1. Accounting principles
  2. Estimates
  3. Reporting entities
Sample Prep Question

1. ________________ is the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.

A. Accounting fraud
B. Financial statement fraud
C. Occupational fraud
D. Material misstatement
Correct Answer: B

- Financial statement fraud is the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.
Sample Prep Question

2. Recording expenses in the wrong period and early revenue recognition are classified as what type of financial fraud scheme?

A. Timing differences
B. Improper disclosures
C. Improper asset valuations
D. Fictitious revenues
Correct Answer: A

- Financial statement fraud might also involve timing differences, or the recording of revenue and/or expenses in improper periods. Matching revenues with expenses; early revenue recognition; and recording expenses in the wrong period are all types of timing differences schemes.
3. ABC Company purchases a material amount of products from another entity whose operating policies can be controlled by ABC Company’s management, but it does not disclose this situation on its financial statements. In which type of improper disclosure scheme has ABC Company engaged?

A. Accounting change
B. Improper asset valuation
C. Significant event
D. Related-party transaction
Correct Answer: D

- Related-party transactions occur when a company does business with another entity whose management or operating policies can be controlled or significantly influenced by the company or by some other party in common. There is nothing inherently wrong with related-party transactions, as long as they are fully disclosed. If the transactions are not fully disclosed, the company might injure shareholders by engaging in economically harmful dealings without their knowledge.
Financial Transactions and Fraud Schemes

Financial Statement Analysis
Financial Statement Analysis

- Vertical Analysis
- Horizontal Analysis
- Ratio Analysis
Percentage Analysis: Vertical and Horizontal

- **Vertical analysis** is a technique for analyzing the relationships between the items on an income statement, balance sheet, or statement of cash flows by expressing components as percentages.
  - Also called “common sizing”

- **Horizontal analysis** is a technique for analyzing the percentage change in individual financial statement items from one year to the next.
**BALANCE SHEET**

<table>
<thead>
<tr>
<th></th>
<th>Year One</th>
<th>Year Two</th>
<th>Change</th>
<th>%Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>45,000</td>
<td>15,000</td>
<td>(30,000)</td>
<td>-67%</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>150,000</td>
<td>200,000</td>
<td>50,000</td>
<td>33%</td>
</tr>
<tr>
<td>Inventory</td>
<td>75,000</td>
<td>150,000</td>
<td>75,000</td>
<td>100%</td>
</tr>
<tr>
<td>Fixed Assets (net)</td>
<td>60,000</td>
<td>60,000</td>
<td>-</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>330,000</td>
<td>425,000</td>
<td>95,000</td>
<td>29%</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>95,000</td>
<td>215,000</td>
<td>120,000</td>
<td>126%</td>
</tr>
<tr>
<td>Long-term Debt</td>
<td>60,000</td>
<td>60,000</td>
<td>-</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Stockholder's Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td>25,000</td>
<td>25,000</td>
<td>-</td>
<td>0%</td>
</tr>
<tr>
<td>Paid-in Capital</td>
<td>75,000</td>
<td>75,000</td>
<td>-</td>
<td>0%</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>75,000</td>
<td>50,000</td>
<td>(25,000)</td>
<td>-33%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>330,000</td>
<td>425,000</td>
<td>95,000</td>
<td>29%</td>
</tr>
</tbody>
</table>

**INCOME STATEMENT**

<table>
<thead>
<tr>
<th></th>
<th>Year One</th>
<th>Year Two</th>
<th>Change</th>
<th>%Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year One</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Sales</td>
<td>250,000</td>
<td>450,000</td>
<td>200,000</td>
<td>80%</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>125,000</td>
<td>300,000</td>
<td>175,000</td>
<td>140%</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>125,000</td>
<td>150,000</td>
<td>25,000</td>
<td>20%</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>50,000</td>
<td>75,000</td>
<td>25,000</td>
<td>50%</td>
</tr>
<tr>
<td>Administrative Expenses</td>
<td>60,000</td>
<td>100,000</td>
<td>40,000</td>
<td>67%</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>15,000</td>
<td>(25,000)</td>
<td>(40,000)</td>
<td>-267%</td>
</tr>
</tbody>
</table>

**Additional Information**

- Average Net Receivables: 155,000
- Average Inventory: 65,000
- Average Assets: 330,000

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Financial Ratios

- *Ratio analysis* is a means of measuring the relationship between two different financial statement amounts.
- Ratios can be used to compare the business to other companies in the same industry.
Examples of Financial Ratios

- Current Ratio
  \[
  \frac{\text{Current Assets}}{\text{Current Liabilities}}
  \]

- Quick Ratio
  \[
  \frac{\text{Cash+Securities+Receivables}}{\text{Current Liabilities}}
  \]
Financial Ratios, continued

- Asset Turnover
  - Net Sales / Average Total Assets

- Debt-to-Equity Ratio
  - Total Liabilities / Total Equity
Sample Prep Question

1. Which of the following is the correct calculation of the quick ratio?

A. Current assets divided by current liabilities
B. Cash plus securities divided by accounts payable
C. Cash plus receivables divided by current liabilities
D. Cash plus marketable securities plus receivables divided by current liabilities
Correct Answer: D

- The quick ratio, often referred to as the acid test ratio, compares assets that can be immediately liquidated. This calculation divides the total of cash, securities, and receivables by current liabilities. This ratio is a measure of a company’s ability to meet sudden cash requirements.
2. The asset turnover ratio, which is used to determine how efficiently assets are used to produce sales, is calculated by dividing net sales by the asset balance at the end of the period.

A. True
B. False
Correct Answer: B

- The asset turnover ratio is calculated by dividing net sales by the average total assets for the period.