“Fraud Case Analysis: Lessons Learned”

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“Accounting Fraud

Case Studies and Practical Implications”

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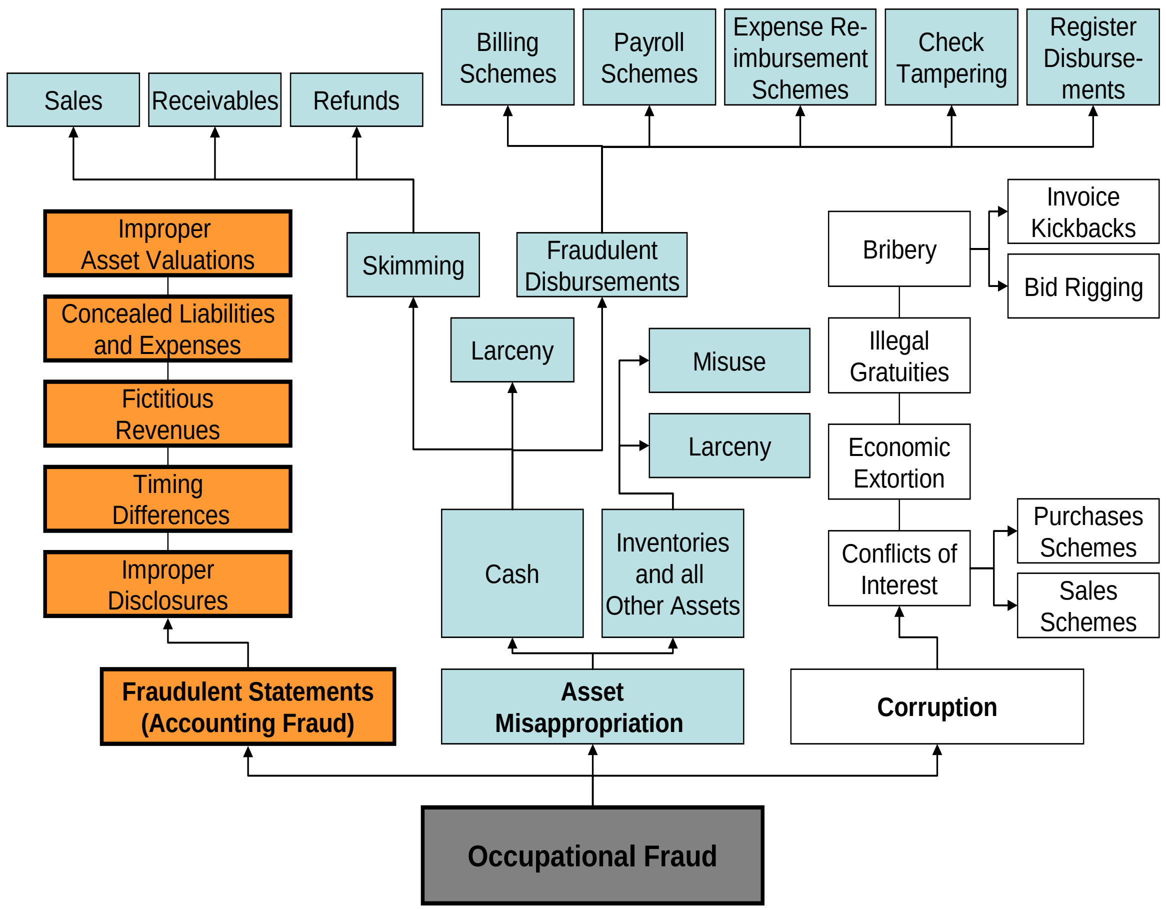
3. Fraud Case Analysis: Lessons Learned

3.1 Types of Fraud

3.1.1 A Classification System for Fraudulent Acts: The Fraud Tree

Joseph T. Wells, chairman and founder of the "Association of Certified Fraud Examiners" (ACFE), has developed a classification system – known informally as the "fraud tree" – that accounts for all of the most common types of fraud. The fraud tree encompasses a wide range of misconduct by executives, managers, and employees of organizations, ranging from petty thefts to sophisticated financial statement frauds. It is illustrated in Exhibit 2 (see *Wells* 2007, p. 46; *ACFE* 2008, p. 7).

Exhibit 2: The Fraud Tree



According to Wells, the types of "occupational fraud" can generally be broken down into three broad categories: *asset misappropriation*, *corruption*, and *fraudulent statements (accounting fraud)*. Within each of these three major categories, there are several sub-categories of fraud scheme types. It should be noted, however, that a number of cases described in this book involve aspects of more than one of the three basic categories. For example, several cases involve both accounting fraud and asset misappropriation, or both accounting fraud and corruption. In these cases where there are multiple schemes, it is impossible to subdivide the losses in order to show exactly how much of the loss was attributable to each of the component schemes. As a consequence, it is necessary to address each of the three major categories and their sub-categories, looking at their effects and identifying how the schemes are committed.

- *Asset misappropriation*

Asset misappropriation schemes are frauds in which the perpetrator steals or misuses an organization's resources. Although "internal theft" and "embezzlement" are commonly used, "asset misappropriation" is a more encompassing term. An employee who wrongly uses company equipment for his own personal benefit has not "stolen" the property, but has "misappropriated" it.

Asset misappropriation is the most common of the three primary categories of occupational fraud. According to the ACFE, approximately 90% of all occupational frauds involve asset misappropriation. Fraudsters – from executives to rank-and-file workers – can be very imaginative in the ways they scam their companies. However, there are two major asset misappropriation types: "cash" and "inventories and all other assets". Crooked employees clearly favour misappropriating cash; the reasons are not very surprising: cash is fungible, has a specific value and can easily be transported. Inventory, on the other hand, may have limited usefulness to a fraudster (except for consumer goods).

Joseph T. Wells has divided asset misappropriation schemes into several distinct sub-categories, which are illustrated in the following table (see *ACFE* 2008, p. 13, as well as the fraud tree in Exhibit 2):

Sub-category	*Description*	*Examples*
Skimming	Cash is stolen from an organization *before* it is recorded on the organization's books and records	- Employee collects payment from a customer but does not record the sale
Cash larceny	Cash is stolen from an organization *after* it is recorded on the organization's books and records	- Employee steals cash and checks from daily receipts before they can be deposited in the bank
Billing schemes	A fraudster causes the victim organization to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases	- Employee creates a shell company and bills employer for nonexistent services - Employee purchases personal items and submits invoice to employer for payment
Payroll schemes	An employee causes his employer to issue a payment by making false claims for compensation	- Employee claims overtime for hours not worked - Employee adds ghost employees to the payroll
Expense reimbursement schemes	An employee makes a claim for reimbursement of fictitious or inflated business expenses	- Employee files fraudulent expense reports, claiming nonexistent personal travel, nonexistent meals, etc.

Check tampering	An employee steals his employer’s funds by forging or altering a check on one of the organization’s bank accounts, or steals a check the organization has legitimately issued to another payee	- Employee steals blank company checks and makes them out to himself or an accomplice - Employee steals outgoing check to a vendor and deposits it into his own bank account
Register disbursements	An employee makes false entries on a cash register to conceal the fraudulent removal of cash	- Employee fraudulently voids a sale on his cash register and steals the cash
Non-cash misappropriations (“inventories and all other assets”)	Any scheme in which an employee steals or misuses non-cash assets of the victim organization	- Employee steals inventory from a warehouse or a storeroom - Employee steals or misuses confidential customer information

The first two sub-categories (skimming and cash larceny) are frauds that target an organization’s *incoming receipts*. The next five sub-categories (billing schemes, payroll schemes, expense reimbursement schemes, check tampering, and register disbursements) target *outgoing disbursements of cash*. The last sub-category (non-cash misappropriations) involves the theft or misuse of physical assets such as inventory or equipment, or the misappropriation of proprietary information.

- <u>*Corruption*</u>

Corruption refers to schemes in which fraudsters use their influence in business transactions in a way that violates their duty to their employers, in order to obtain a benefit for themselves or someone else. For example, employees might receive or offer bribes, extort funds from third parties, or engage in conflicts of interest.

Joseph T. Wells has broken down corruption schemes into four sub-categories (see *Wells* 2003, p. 51; *Wells* 2007, pp. 281–282). The first three sub-categories are very similar in nature, and it is important to understand the differences that exist among these categories.

Sub-category	*Description*	*Examples*
Bribery	The offering, giving, receiving or soliciting of anything of value to influence the outcome of a business transaction	- Undisclosed payments made by vendors to employees of pur-chasing companies (“kickbacks”) - Employee fraudulently assists a vendor in winning a contract through the competitive bidding process (“bid rigging”)
Illegal gratuities	Similar to bribery, except that something of value is given to *reward* a business decision, rather than to *influence* it	- Purchasing agent is lavished with an expensive vacation or other items when a vendor’s contract is approved
Economic extortion	Basically the flip side of bribery: instead of a vendor offering a payment to an employee to influence a decision, the employee demands a payment from a vendor in order to make a decision in that vendor’s favour	- A corrupt lending officer demands a kickback in exchange for approving a loan

Conflicts of interest	An employee, manager or executive of an organization has an undisclosed personal economic interest in a transaction that adversely affects the company or the shareholders' interests; as with other types of corruption, these schemes involve the exertion of the insider's influence to the detriment of the company	- A victim company unwittingly buys something at a high price from a company in which one of its employees has a hidden interest ("purchases schemes"; "over-billing schemes") - A victim company unwittingly sells something at a low price to a company in which one of its employees has a hidden interest ("sales schemes"; "underselling schemes")

- *Fraudulent statements (Accounting fraud)*

The third major category of occupational fraud generally involves the intentional misstatement or omission of material information from the organization's financial reports. These are the cases of "cooking the books" that often make front page headlines and that can have crippling effects on even the largest companies (as we have seen with the high-profile frauds described in Chapter 2). Common examples of accounting fraud include overstating assets and revenues, as well as understating liabilities and expenses.

Accounting fraud differs from the other forms of occupational fraud: the typical goal of these "accounting schemes" is not to directly enrich the perpetrator, but rather to mislead third parties (investors, owners, regulators, etc.) as to the profitability or viability of an organization. Moreover, accounting fraud usually causes considerably more damage than the frauds in the other two major categories. It can also have a tremendous impact on the organization's shareholders. When looking at the losses resulting from accounting fraud, we are often measuring lost market capitalization or lost shareholder value, rather than direct losses of assets. Thus, the losses from accounting fraud have a different character than those resulting from the other forms of occupational fraud.

Chapter 3.1.2 focuses on accounting fraud with more specificity, presenting a meaningful analysis of how fraudsters misreport financial information and how they mislead those who read it.

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3.1.2 A Taxonomy of Accounting Fraud Types

Referring to the fraud tree, most accounting schemes can be classified in one (or more) of these sub-categories: *(1.) Improper asset valuations, (2.) Concealed liabilities and expenses, (3.) Fictitious revenues, (4.) Timing differences, and (5.) Improper disclosures*. The schemes listed below reflect the major accounting fraud techniques; they clearly exceed the boundaries of the normal reporting flexibility that exists within GAAP. Many fraud and forensic accounting specialists suggest that it is more important to be familiar with this basic taxonomy of fraudulent acts than to understand the complexities and nuances of one type of fraud in detail.

(1.) *Improper asset valuations*

Improper asset valuations usually fall into one of these categories: fixed assets, inventory, accounts receivable, and cash and cash equivalents. (The two most common asset accounts misstated, however, are inventory and accounts receivable.)

- *Fixed assets*

- Recording fictitious fixed assets by making up purchases and creating fictitious documents
- Equipment is being leased, not owned, and the fact is not disclosed during the audit
- Reporting of fixed assets at inflated values with phony valuations to support them
- Inflating the value of fixed assets by failing to record impairments of long-lived assets and of goodwill
- Allocating too much of the total purchase price in an acquisition to fixed assets
- Capitalization of expenses into fixed assets
- Amortizing capital expenditures over estimated useful lives that are unduly optimistic
- Overvalued intangible fixed assets
- Overvalued development projects
- Misclassifying fixed assets into accounts in which they do not belong, thereby skewing financial ratios and helping to comply with loan covenants or other borrowing requirements

- *Inventory*

- Fictitious (“phantom”) inventory: empty boxes or hollow squares in stacked goods
- Mislabelled boxes of inventory counted as “real” inventory when they contain scrap, obsolete items, or lower value materials
- Consigned inventory or rented inventory counted as own inventory
- Increasing the inventory counts for items/locations the auditor did not count
- Overstating inventory in transit between locations
- Physically moving inventory and counting it at two locations (double counting)
- Including in inventory goods recorded as sold but not yet shipped
- Arranging for false confirmation of inventory held by others
- Inventory mechanically overvalued by altering aging, ignoring signs of obsolescence, etc. (inadequate obsolescence reserve)
- Not recognizing permanent markdowns in calculation of inventory
- Capitalization of expenses into inventory

- *Accounts receivable*

- Fictitious accounts receivable, commonly concealed by providing false confirmations of balances to auditors (in the case of phony customers, e.g., the mailing address is typically a mailbox under the control of the fraudsters, a home address, or the business address of a co-conspirator)
- Failure to write off uncollectible accounts receivable as bad debts; writing off uncollectible accounts receivable in a later period
- Failure to establish an adequate allowance for doubtful accounts receivable, thus overstating receivables
- Taking artificial steps to make accounts receivable appear current

- *Cash and cash equivalents*

- Recording bank transfers as cash received from customers
- Moving cash from one bank to another and recording the deposit but not the withdrawal
- Manipulating cash received from related parties
- Providing money to a customer to pay for an order
- Paying a commission to a third party to provide funds to a customer to pay the amount due
- Outstanding checks included in balance of cash

(2.) *Concealed liabilities and expenses*

There are several common methods for concealing liabilities and expenses. Usually, these methods are easier to commit than, e.g., falsifying sales transactions. For auditors, missing transactions are generally harder to detect than improperly recorded ones because there is no audit trail.

- Failure to record liabilities/expenses (e.g., a multi-million dollar judgment against the company from a recent court decision is simply ignored; vendor invoices are thrown away or stuffed into drawers rather than posted into the accounting system)
- Keeping liabilities off the books improperly by using related but unconsolidated "special purpose entities" (SPEs)
- Reporting equity rather than a liability when cash is received
- Unrecorded liabilities for inventory purchases
- Failure to accrue expected liabilities for litigation, tax disputes, etc.
- Unrecorded warranty or service liabilities
- Failure to properly record the expenses associated with sales returns and customer allowances stemming from customer dissatisfaction
- Capitalization of expenses, thus overstating income during the current period (as the assets are depreciated, income in subsequent periods will be understated)

(3.) *Fictitious revenues*

By far, the most common way to perpetrate accounting fraud is improper revenue recognition. The revenue misstatements are primarily due to recording revenue prematurely (see *No. 4, "Timing differences"*) or fictitiously ("made up" sales; "fabricated" or "bogus" revenue). There is a great variety of techniques to record revenue fictitiously, including the following:

- Preparing phony invoices for phony customers (“phantom” or “fake” customers)
- Preparing phony invoices for legitimate customers (but not mailing the invoices); at the beginning of the next accounting period, the “sales” may be reversed to conceal the fraud
- Artificially inflating or altering invoices, reflecting higher amounts than actually sold (false sales documentation)
- Making shipments to customers for non-ordered goods or on cancelled or duplicate orders, and recording revenue (unauthorized shipments)
- Making shipments to a public warehouse, the seller’s agent or other intermediaries without the instruction by customers, and recording revenue
- Shipping defective products and recording revenue at full, rather than discounted, prices
- Fictitious sales to related parties (“sham transactions”)
- Barter transactions (“trade barter”): exchange of similar or near-simultaneous assets; revenue is recorded when it shouldn’t be recorded
- “Round tripping” (“wash sales”): revenue is recorded although there is no substantive business purpose for structuring the transactions in such a manner
- Including one-time gains as part of revenue
- Recording refunds from suppliers as revenue
- Recognizing customer deposits as completed sales

(4.) *Timing differences*

As noted above, improper revenue recognition may also involve timing differences, that is, the recording of revenue in improper periods (mainly, too soon; “revenue precognition”).

- Holding books open beyond the end of the reporting period: shipments made to customers after the end of a period, and recognized as sales of this period (improper cut-off of sales, including back-dating of contracts and other sales documents)
- Fraudulent “bill-and-hold sales”: sales billed to customers prior to delivery and held by the seller (the seller retains physical possession until customers request shipments; the shipments will occur at a later, yet-to-be-determined date)
- Recording revenue even though the terms of the sales are amended subsequently by side letter agreements
- Recording revenue when customer’s obligation to pay depends on the resale to a third party, e.g., an end user (consignment sales)
- Recording revenue when customer’s obligation to pay depends on the final acceptance following an evaluation/testing period (customer has the right of return)
- Recording revenue when future services or continuing vendor involvement are still due (delivery is not yet complete)
- Manipulating the percentage of completion (PoC) in long-term construction contracts: accelerating the estimated PoC for projects in process
- Sales in which substantial uncertainty exists about the seller’s ability to comply with performance guarantees
- Sales of merchandise shipped in advance of the scheduled shipment date without customer’s agreement (ordered, but shipped early)
- Pre-invoicing of goods in the process of being assembled
- Partial shipments, but invoiced and recorded as complete sales (some but not all of the components required for operation are shipped)

- Insidious “channel stuffing” (also known as “trade loading”): sale of an unusually large quantity of a product to distributors or resellers, who are encouraged to overbuy through the use of deep discounts and/or extended payment terms; increase of short-term earnings, but “theft” of sales from the next period

(5.) *Improper disclosures*

Improper disclosures relating to accounting fraud usually involve misrepresentations in the notes, misrepresentations in the non-financial statement sections of financial reports (such as the MD&A), and overall misrepresentations about the nature of the company or its products, usually made through news reports, press conferences, interviews, and elsewhere.

- Failure to disclose loan covenants, warranty costs, or contingent liabilities (e.g., purchase commitments; corporate guarantees of personal bank loans taken out by officers)
- Inadequate disclosure of impairment in value of fixed assets
- Failure to disclose subsequent events that undermine the reported values of assets, that indicate unrecorded liabilities, or that adversely reflect on management integrity (e.g., court judgments; regulatory decisions)
- Inadequate disclosure of related party transactions, or less-than-arm’s-length transactions
- Improper disclosure of management compensation
- Improper disclosure of fraud committed by officers, executives, and others in positions of trust
- No disclosure of accounting changes: e.g.,
  - changes in accounting principles if the changes cause the company’s financial statements to appear weaker
  - changes in estimates such as the useful lives and the salvage values of depreciable assets
  - changes in the reporting entities in order to improve results
- No disclosure of technical default or financial distress

However, there may also be circumstances in which it is not in a company’s interests to appear to be exceptionally profitable. Especially large and high-profile companies may have the motivation to manage their earnings *downward* in an effort to minimize tax payments, to make negotiations with trade unions easier, to refuse price concessions to customers, or to set up “cookie-jar-reserves” for bad times. Examples of *“accounting frauds going the other way”* include:

- Omitting fixed assets
- Charging a fixed asset to expense
- Understating fixed assets directly or through improper depreciation (e.g., writing off future years’ depreciation)
- Omitting inventory
- Overstating bad debts expenses, thus understating receivables
- Expensing capital expenditures that should be depreciated over a period of time, thus lowering income during the current period
- Overstating liabilities and expenses
- Overstating restructuring charges (“big bath accounting”)
- Shifting revenues to a later period

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3.2 The Warning Signs of Fraud

3.2.1 A Schedule of Fraud Red Flags

In almost all of the cases described in this book the signs of impending doom have been apparent for some time – for those who wished to see them. According to numerous fraud surveys, the most frequent reason why frauds were not detected earlier was insensitivity to the warning signs. Most of the reported frauds could have been detected more quickly had the warning signs not been ignored. These warning signs are often being referred to as fraud risk factors, fraud risk indicators, or "red flags". Red flags are cues that should be picked up by external or internal auditors. They may alert auditors (i.e., make them more watchful and suspicious) to the possibility that someone in the company might be engaged in some form of fraudulent or improper conduct.

The presence of red flags does not necessarily indicate that fraud *is* occurring within the organization. Their presence, however, either individually or in combination, *could* indicate the occurrence of fraud or an increased likelihood thereof. Red flags should therefore, when encountered, trigger a higher level of professional scepticism.

The aim of this schedule is to act as an aid to all anti-fraud-practitioners when considering fraud risk mitigation initiatives. Although the red flags cover a broad range of situations, they are only examples and, accordingly, it may be helpful to consider additional or different red flags. Not all of these warning signs are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics. Also, the order of the red flags is not intended to reflect their relative importance or frequency of occurrence. And, to say it clearly, a positive answer to any of the following red flags does not necessarily imply that fraud has occurred. Rather, a positive answer indicates that a heightened risk of fraud may exist and further evaluation may be prudent.

(1.) *Economic or industry operating conditions*

- High degree of competition or market saturation, accompanied by declining margins
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- High vulnerability to rapid changes, such as changes in technology or product obsolescence
- Operating results highly sensitive to economic factors, such as inflation, interest rates, unemployment, currency shifts, etc.
- New accounting, statutory, or regulatory requirements; adverse legal circumstances

(2.) *Entity operating conditions (business development, organizational structure)*

- Operating on a crisis basis: loss of significant customers, insufficient working capital, high debt burden, dependence on one or two products, costs rising faster than sales, problems with collecting receivables, declining order book, stock losses, problems with renewal of licences to do trade, problems with liquidity and proximity of borrowing limits, etc.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover immanent; pressures to merge

- Profitability expectations of investment analysts, institutional investors, significant creditors, or other external parties that are unduly aggressive or unrealistic
- Excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management
- Need to obtain additional funds to stay competitive, including financing of major R&D and capital expenditures
- Marginal ability to meet stock exchange listing requirements, or debt repayment or other debt covenant requirements
- Continuous problems with regulatory agencies; complaints by stock exchange regulators
- Adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards
- Period of rapid growth and expansion; significant number of acquisition transactions
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- Earnings expected to be managed at the subsidiary or division level, creating pressures on lower-level managers to meet higher-level management expectations
- Adverse consequences on lower-level managers if subsidiaries or divisions fail to meet budgeted, projected, or forecasted results
- Overly unstable organizational structure (e.g., high turnover of senior management or board members)
- Operating without budgetary control; budgets not reviewed or senselessly justified
- Difficulty in determining the individuals or companies that have controlling interest in the entity
- Significant business operations located or conducted across international borders in jurisdictions where differing laws and cultures exist
- Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification
- Significant related-party transactions not in the ordinary course of business, or with related entities not audited or audited by another firm
- A strong market position or ability to dominate a certain industry sector that allows the entity to dictate conditions to suppliers or customers that may result in inappropriate or non-arm’s-length transactions

(3.) *Control structure (monitoring of management, internal control components)*

- Ineffective board of directors or audit committee oversight over the financial reporting process
- Directors with apparently little experience
- Family relationships among directors and/or officers
- Domination of management by a single person or small group without compensating controls
- Ineffective internal audit department
- Management and internal auditors exhibiting a less-than-diligent attitude regarding the entity’s anti-fraud programs and controls
- Inadequate monitoring of controls (including automated controls and controls over interim financial reporting)
- Management override of controls
- Ineffective IT department
- Ineffective accounting and information systems; poor data processing controls

- Significant accounting system changes, particularly the implementation of new, complex systems, or where control effectiveness was not adequately considered
- Major structural changes, such as acquisitions or spin-offs, that might have affected internal controls
- High turnover rates of accounting, internal audit, compliance, or IT staff
- No clear separation of duties
- Inadequate system of authorization and approval of transactions
- Inadequate physical safeguards over cash, inventory, or fixed assets
- Lack of mandatory vacations for employees performing key control functions

(4.) *Top management*

- Ineffective implementation, communication, or enforcement of the entity's values or ethical standards
- Communication of inappropriate values or ethical standards
- Known history of violations of securities laws or other laws and regulations (criminal record)
- Claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest in maintaining or increasing the entity's stock price or earnings trend; extreme focus on quarterly earnings
- An interest in employing inappropriate means to minimize taxable income
- Undue concern with the need to improve the image/reputation of the entity
- A practice of creating expectations in, for example, overly optimistic press releases or annual report messages
- A practice of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Significant portions of the compensation (e.g., bonuses and stock options) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow
- Significant financial interests in the entity
- Personal guarantees of debts of the entity
- Senior executives living beyond their means; unusually high personal debts; extensive involvement in speculative investments; excessive gambling habits; alcohol or drug problems
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated
- Undue family or peer pressure to succeed; belief that job is in jeopardy
- Lack of personal stability such as frequent changes of job, residence, partners and acquaintances
- Wheeler-dealer-attitude or desire to "beat the system"
- Senior executives not taking vacations
- Senior executives displaying a propensity to take undue risks, a hostile attitude towards the auditors, and/or significant disrespect for regulatory bodies
- Failure to identify business risks on a timely basis and/or to adequately monitor identified risks; failure to pay attention to details
- No signs of personal ethics; undisclosed conflicts of interest
- Using several different audit firms over time; frequent changes in auditors
- Engaging several legal firms; frequent changes in legal counsels
- Making use of many different banks, and excessive numbers of bank accounts

(5.) *Relationship between management and auditor*

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters (particularly about aggressive application of accounting principles that increase earnings)
- Undue demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
- Undue pressure on the auditor, particularly through the fee structure
- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
- Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection of personnel assigned to the audit engagement
- Management lying to the auditor or being overly evasive in response to audit inquiries; reluctance to provide auditor with requested information
- Auditor's experience with management indicating a degree of dishonesty; key managers considered insincere and/or inexperienced
- Management engaging in "opinion shopping"
- Management failing to correct known misrepresentations on a timely basis
- Management being unwilling to address issues that could result in significant financial statement adjustments or adverse disclosures
- Management deciding to fix accounting "in the next period"
- Recurring attempts by management to justify inappropriate accounting on the basis of materiality
- Frequent and significant difficult-to-audit transactions; one or a few specific transactions that have a material effect on the financial statements
- New client with no prior audit history or insufficient information from the predecessor auditor

(6.) *Accounting staff*

- Inadequate staffing of the accounting department (quality and quantity); indications that the qualifications of key personnel need significant improvement
- Accounting personnel exhibiting inexperience or laxity in performing their duties
- Accounting personnel displaying significant resentment of authority
- Rapid turnover of key accounting personnel, through resignation or dismissal
- Inadequate background and reference checking before hiring accounting staff
- Inadequate training programmes
- Inadequate communication about disciplinary codes and codes of conduct
- Pay levels not commensurate with responsibilities
- Too much trust placed in key employees

(7.) *Journal entries*

- Entries made to unrelated, unusual or seldom-used accounts
- Entries made by individuals who do not typically make entries (e.g., an entry made by the CEO or CFO that typically would be made by lower-level accounting personnel)
- Entries recorded at the end of the period or recorded as post-closing entries that have little or no explanation or description

- Entries made to account pairings that appear unusual, such as a debit entry to an asset account and a credit entry to an expense account
- Entries having descriptions that include a phrase implying that an entry was made at the direction of a superior (such as “per Mary Jones”, “as indicated by Adam Smith”)
- Entries reversed during the beginning of the subsequent period
- Entries made either before or during the preparation of the financial statements that do not have account numbers
- Entries containing round numbers or a consistent ending number

(8.) *Irrational ratios*

- Rapid growth or unusual profitability, especially compared to other companies in the same industry
- Unusual growth in the number of days sales in receivables
  => (accounts receivable / sales) x 365
- An unusual volume of sales to entities whose substance and ownership is not known
- An unusual surge in sales by a minority of units within a group, or of sales recorded by corporate headquarters
- Increase in inventory without comparable sales increases
- Unusual increase in gross profit margin, or margin in excess of industry peers
- Unusual decline in the number of days purchases in accounts payable
  => (accounts payable / purchases) x 365
- Allowances for sales returns, warranty claims, etc. that are shrinking in percentage terms or are otherwise out of line with industry peers
- Allowances for bad debts, excess and obsolete inventory, etc. that are shrinking in percentage terms or are otherwise out of line with industry peers
- Unusual change in the relationship between fixed assets and depreciation
- Adding to assets while competitors are reducing capital tied up in assets
- Cash flows that are not correlated with earnings; recurring negative cash flows from operations while reporting earnings and earnings growth
- Revenues and earnings that consistently and precisely meet analysts’ expectations
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant estimates used in the financial reporting process unrealistic or inconsistent with actual historical results or with the performance of other entities in the same industry
- Disclosures and other information in the MD&A overly optimistic or inconsistent with the entity’s performance

3.2.2 Advantages and Limitations of the “Red Flags Approach”

The use of red flags checklists is wide-spread today, in textbooks for accounting students as well as in practice aids for auditors. Regarding the advantages of red flags, there is general agreement that they (1) appropriately raise the auditor’s awareness of the possibility of fraud, (2) add structure to the consideration of fraud, and (3) could increase the possibility of detecting fraud. Knowing the most important red flags should help auditors to do a better job of assessing fraud risk. However, there are also limitations of the use of these warning signs (see *Krambia-Kapardis* 2001, p. 51):

- While red flags are associated with fraud, the association is not perfect. Red flags are only indicators, not evidence.
- Red flags are not always obvious and may be difficult to observe. Therefore, “red handkerchiefs” might be a more accurate term.
- Red flags focus attention on specific cues and could prohibit the auditor from identifying or observing other reasons.
- Red flags may indicate other risks, not exclusively fraud. For example, weak controls increase the risk of error as well as the risk of fraud.
- Red flags can be ambiguous. For example, the ledger clerk drives a Ferrari because he has won a lottery.
- There is no linear relationship between red flags and fraud risk. Fraud risk indicators cannot be summed up to derive the overall result. In certain circumstances, a few risk factors alone may cause concern.

Fraud surveys reveal an interesting pattern. Auditors generally perceive “attitude factors” to be more important warnings signs than “situational factors”. For example, dishonest, hostile, aggressive and unreasonable management attitudes were considered more significant than adverse economic or industry conditions. Therefore, if many of the most significant “attitude factors” are present in a specific setting, auditors should be even more vigilant.

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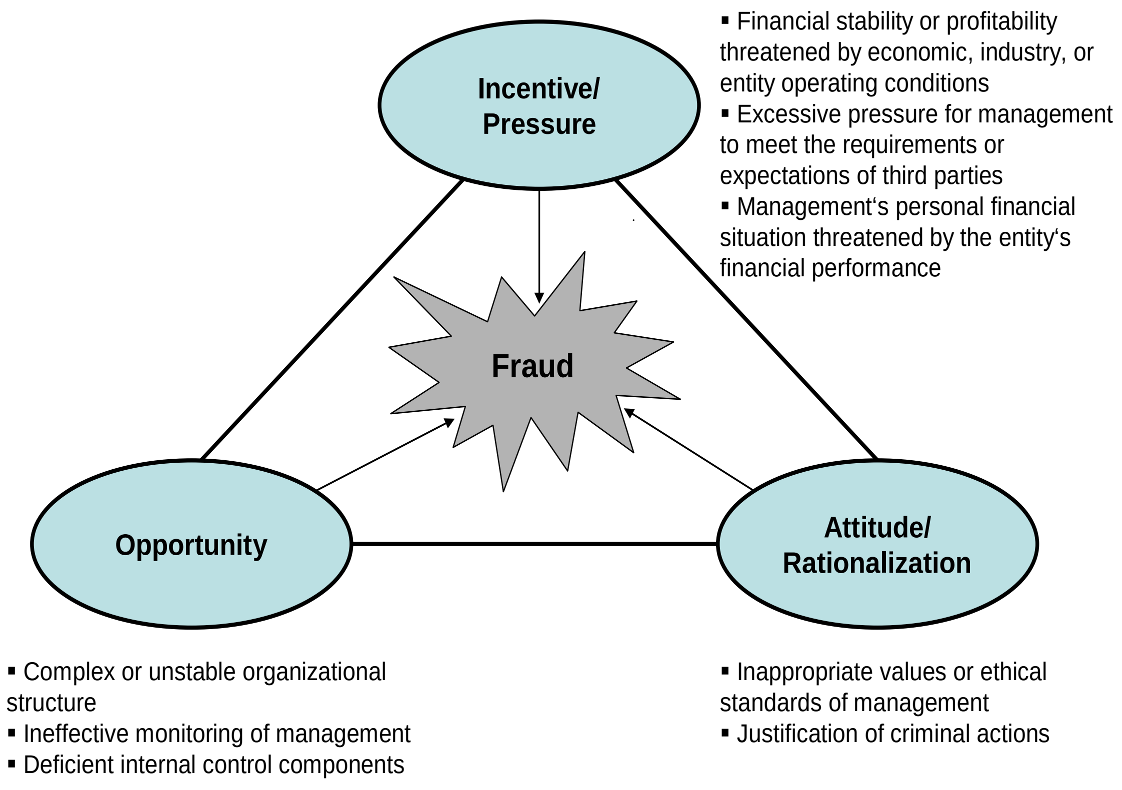
3.3 Fraud Theories

3.3.1 The Fraud Triangle

Although it is common knowledge today that people may commit fraud, it is often not understood why they do it. Donald R. Cressey, one of the pioneers in fraud research, came to the conclusion that fraud is most likely to occur when three critical elements come together: *incentive/pressure*, *opportunity*, and *attitude/rationalization*. In the case of accounting fraud, for example, the incentive/pressure might be the need to make earnings look better in order to meet debt covenants. The opportunity might be a weak audit committee or weak internal controls, and the attitude/rationalization might be that "we'll only cook the books until we get over this financial hump". Cressey developed a three-pronged framework, commonly known as the "fraud triangle", which is a very useful tool for fraud-fighters seeking to understand and manage fraud risks. The fraud triangle is shown in Exhibit 3 (see, e.g., *Montgomery/Beasley/ Menelaides/Palmrose* 2002, p. 63; *Wells* 2007, p. 7).

Exhibit 3: The Fraud Triangle



According to Cressey, each of these three elements is necessary in order for a person to actually commit a fraud. The absence of any one of them would not allow a person to perpetrate a fraud. However, the three elements in the fraud triangle are also interrelated. The greater the perceived opportunity or the more intense the perceived incentive/pressure, the less rationalization it takes to motivate someone to commit a fraud. Likewise, the more dishonest a person is, the less opportunity or the less pressure it takes to motivate fraud.

Fraud-fighters focus their preventive efforts primarily on only one of the three elements of the fraud triangle: *opportunity*. Of course, removing or lessening the opportunity to commit fraud (e.g., by enforcing certain types of internal controls and by implementing effective risk management policies) is decisive for any fraud prevention program. Moreover, opportunity often represents the only element an organization has any chance of controlling. Nevertheless, fraud-fighters should also focus on the incentives and pressures motivating fraud as well as on the attitudes and rationalizations of the perpetrators.

Incentives and pressures can come from a variety of sources. With regard to accounting fraud, most incentives/pressures involve an immediate need to report financial results better than actual performance. Besides, many accounting frauds are greed-related: executives put their personal enrichment through bonuses and stock options ahead of the responsibilities to their company and its shareholders. Eventually, in some cases, the motive for accounting fraud is also the "challenge to beat the system": the fraudsters think that they are smarter than anyone else, and that no one can stop them. In making fools of their victims, the fraudsters seem to take delight in the fraudulent act itself rather than simply in the outcome. Scientists call this motivation the "ego challenge": it relates to the sense of superiority over others and to the gratification obtained from the mastery of an exciting situation. It also reflects the pride of a professional "con artist".

Attitudes are the values and ethical standards that allow an individual to knowingly and intentionally commit a dishonest act. Research shows that only about 20% of business executives are honest all the time. Another 20% are basically dishonest, and about 60% are "situationally honest" (that is, honest where it pays to be honest and dishonest where it pays to be dishonest). However, most of the organizations are convinced that their executives are among the 20% who are honest. Unfortunately, quite frequently, this is not the case.

Rationalization is how the fraudster justifies his inappropriate actions. In other words, it is the fraudster's internal dialogue that provides the self-justification for his malfeasance. Such attempts at prospective excuse have been termed "techniques of neutralisation": neutralisation paves the way to fraud by nullifying moral objections. For example, in the case of accounting fraud, a perpetrator might say:

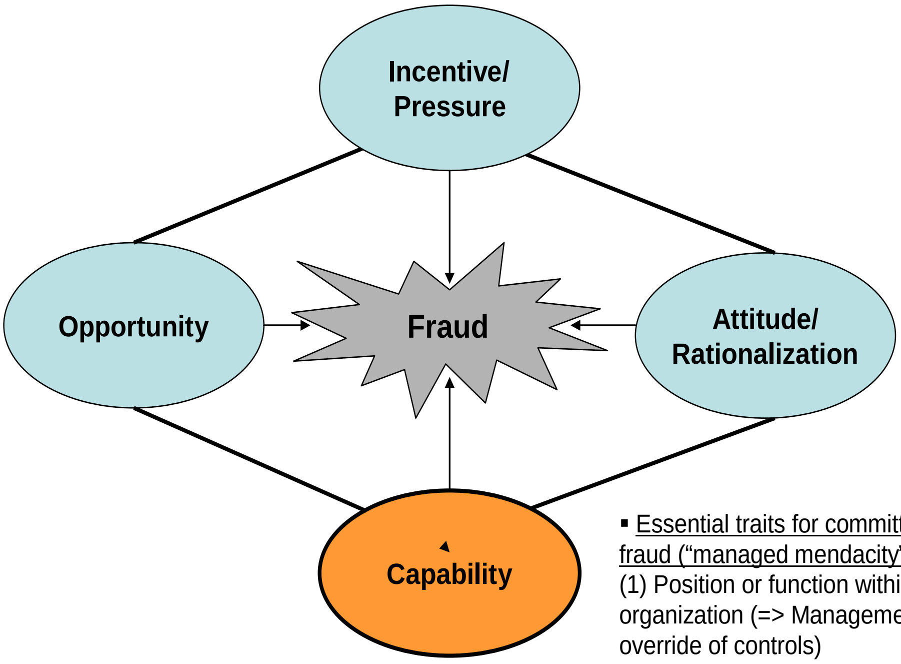
- "There is no harm done. Nobody will get hurt."
- "It's for a good purpose."
- "We'll fix the books as soon as we get over this financial difficulty."
- "Business is business. Everybody else does it."

Of course, there are countless other rationalizations. These, however, are representative and may serve as adequate examples to illustrate the role that rationalization plays in fraud: the fraudster thinks of himself as honest; he is convinced that what occurs is not bad or wrong.

3.3.2 The Fraud Diamond

David T. Wolfe and Dana R. Hermanson, two important American fraud experts, believe that the fraud triangle can be enhanced by considering a fourth element. In addition to incentive/ pressure, opportunity, and attitude/rationalization, their four-sided "fraud diamond" also considers an individual's *capability* to commit a fraud. The person must have the necessary traits and abilities to recognize a particular fraud opportunity and to execute the fraud. According to Wolfe and Hermanson, there are six essential "components of capability" (see *Wolfe/Hermanson* 2004, as well as Exhibit 4):

Exhibit 4: The Fraud Diamond



▪ <u>Essential traits for committing fraud (“managed mendacity”):</u>
(1) Position or function within the organization (=> Management override of controls)
(2) Intelligence (“brains”), creativity and experience
(3) Strong ego and great confidence
(4) Coercion skills
(5) Effective and consistent lying
(6) Immunity to stress

(1) The person’s position or function within the organization must furnish the ability to exploit the opportunity for fraud. More specifically, the person must have the ability to circumvent (or “to override”) the internal control system.
(2) The person must also be smart enough to “pull it off”. Most of the accounting frauds are being committed by intelligent, creative and experienced people with a thorough understanding of internal control weaknesses and vulnerabilities.
(3) Besides, the typical fraudster has a strong ego and great confidence that he won’t be detected, or he believes that he could easily talk himself out of trouble if caught. A common personality type among fraudsters is the “egotist”: a person driven to succeed at all costs, self-absorbed, bordering on narcissism. The “egotist” believes that he is superior, unique and “chosen”, and he is likely to have an inflated view of his own abilities as well as an excessive need for attention and admiration.
(4) Furthermore, a successful fraudster can coerce others to commit or conceal fraud. He is able to convince colleagues and employees to go along with the fraud or to simply look the other way. In this context, another common personality type among fraudsters is the “domineering bully”, who demands unquestioning loyalty of those who work for him and who creates a culture of fear rather than respect. The typical “bully” tends to surround himself with organizational conformists who can easily be dominated, and he is likely to respond angrily to criticism. He is also ruthless in dealing with others and usurps special privileges that “ordinary people” don’t have an entitlement to.
(5) A successful fraudster also lies effectively and consistently. To avoid detection, he is able to look auditors, investors, and others right in the eye and lie convincingly. And he can keep track of his lies, so that the overall story remains plausible.

(6) Eventually, a typical fraudster deals well with stress. Managing accounting fraud over a long period of time can be extremely stressful. There is the constant need to conceal the fraud, and there is always the risk of detection. In that context, a final common personality type among fraudsters is the “risk lover” (or “risk seeker”), who likes to engage in risky behaviour and has a much stronger “risk appetite” than a normal and more “grounded” executive.

3.3.3 Other Major Fraud Theories

In addition to the “traditional” theories of fraud (such as the fraud triangle or the fraud scale), Martin T. Biegelman and Joel T. Bartow have designed some important theories based on their many years of experience as fraud investigators. Although the concepts may seem trivial, they “speak volumes” about how fraud is committed (see *Biegelman/Bartow* 2006, pp. 36–40).

- *The “Tip of the Iceberg Theory”*

When first discovered, very few frauds yield their true extent. Like most of an iceberg is hidden below the water surface, the fraud that is first seen is often just a small part of the actual deceit. As the fraud investigation is being conducted, a much larger fraud is usually revealed, and the amount of losses increases.

- *The “Potato Chip Theory”*

Committing fraud successfully can become addictive. Just as someone is unable to eat only one potato chip, once a perpetrator starts to commit fraud (and gets away with it), he cannot stop. He will commit fraud after fraud, getting bolder and bolder each time and possibly even branching out to new frauds. However, experience has shown that he will eventually make a fatal mistake, leading to detection. Some time, each criminal makes a mistake, no matter how smart he thinks he is.

- *The “Rotten Apple Theory”*

It is a popular saying that one rotten apple can infect an entire good barrel. Likewise, in organizations, leaders who lack integrity and turn to fraud can damage the people they lead. When there is a poor “tone at the top” or even a “culture of non-compliance”, a breakdown of policies and rules occurs. The employees will copy the fraudulent behaviour of their bosses and will say: “Management is dishonest, so I can be dishonest, too.”

- *The “Low-Hanging Fruit Theory”*

Although priority attention has to be given to high-risk frauds such as fraudulent financial statements, one must not forget about the lower-risk (but high occurrence) frauds such as the various forms of asset misappropriation. Fraud-fighters should ensure that they don’t overlook these “low-hanging frauds”. These are usually rather simple frauds that don’t take a significant amount of investigative time. Besides, by stopping these frauds, the company sends a strong message about its commitment to fraud prevention. And the fraudster may be removed before he is able to perpetrate a much more complex and serious fraud.

One of the most prominent fraud theories, however, was put forth by James Q. Wilson, a well-known American political scientist, and George L. Kelling, a renowned criminologist.

The so-called *"broken windows theory"* suggests that disorderly conditions breed bad behaviour, and that fixing them can help prevent crime. If a window in a building is broken and is left un-repaired, the rest of the windows will soon be broken as well. To stop this "downward spiral", the first broken window needs to be repaired quickly – literally and metaphorically. As Wilson and Kelling put it, "one un-repaired broken window is a signal that no one cares, and so breaking more windows costs nothing".

The theory was first tested scientifically by the American psychologist Philip G. Zimbardo. He arranged to have an automobile without license plates parked with its hood up on a street in the Bronx, New York City. The car was attacked by vandals within ten minutes of its abandonment. The first vandals to arrive removed the radiator and the battery. Within a few hours, virtually everything of value had been removed. Then, random destruction began: windows were smashed, parts torn off, upholstery ripped. Eventually, the car had been turned upside down and utterly destroyed. However, when Zimbardo parked a comparable automobile on a street in Palo Alto, California, this car remained untouched for more than a week.

The broken windows theory sends two strong messages to corporations as well: (1) the environment greatly influences people's behaviour and thinking, and (2) stopping minor offences and restoring order will prevent more serious malfeasance.

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