

Chapter 3

A Framework for Detecting Financial Statement Fraud

Learning Objectives

- Become knowledgeable about the framework for detecting financial statement fraud.
- Learn how to identify financial statement fraud exposures.
- Understand how information regarding a company's management and directors, relationships with others, nature of organization and industry, and financial results and operating characteristics can help assess whether the likelihood for financial statement fraud is high or low.

The first two segments provided background of the financial statement fraud problem. It is now time to roll up our sleeves and learn how to better detect its occurrence. In this segment, we provide a framework for detecting financial statement fraud of all types. In subsequent segments, we deal with specific types of management fraud and apply the concepts discussed in this segment to each major type of fraud. Detecting financial statement fraud, or any type of fraud for that matter, involves a four-step process:

1. Identify fraud exposures,
2. Understand the kind of symptoms the fraud exposures exhibit,
3. Use various kinds of analyses to actively look for relevant symptoms, and
4. Follow up on symptoms observed to determine whether they relate to fraud or are occurring because of some other reason.

In this segment, we will spend most of our time discussing factors that provide fraud exposures or incentives to management to commit financial statement fraud. Many of the motivations and exposures are generic, meaning they are the same regardless of the type of organization being examined or the type of fraud scheme used by management to perpetrate fraud. Understanding the symptoms that various frauds exhibit, actively looking for relevant symptoms, and following up on observed symptoms, on the other hand, are usually steps that are associated with specific types of fraud. Therefore, these last three steps will be integrated into later discussions where we deal with various kinds of financial statement fraud schemes.

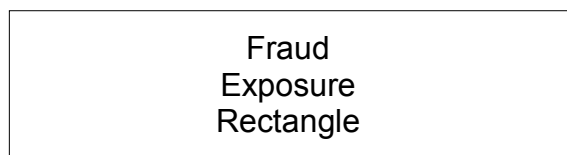
Identifying Fraud Exposures

Identifying fraud exposures is one of the most difficult steps in detecting financial statement fraud. Correctly identifying exposures means that you must clearly understand the operations and nature of the organization you are studying, as well as the nature of its industry and competitors. You must have a good understanding of the organization's management and what it is that motivates them, as well as the way the company is organized. It also means that you must be aware of relationships the company has with other parties, and the influence that each of those parties has on your client and its officers. Fraudulent financial statements are rarely detected by analyzing the financial statements alone. Rather, financial statement fraud is usually detected when the information in the financial statements is compared with the real-world assets those numbers are supposed to represent, and the context in which management is operating and being motivated. Fraud is often detected by focusing on the changes in reported assets, liabilities, revenues, and expenses from period to period or by comparing company performance to industry norms. In the Z-Best fraud case for example, each period's financial statements looked fine. It was only when the change in assets and revenues from period to period were examined, when assets and revenues reported in the financial statements were compared with the actual building restoration projects, and when the motivations of Barry Minkow and related parties were may known, that it became obvious that the financial statements were misleading.

In identifying management fraud exposures, it is useful to think of an *exposure rectangle*. On one corner of the rectangle are the *management and directors* of the company. On another corner are the *relationships* the company has with other entities. On the third corner is the nature of the *organization* you are examining and the *industry* that organization operates in, and on the final corner are the *financial results and operating characteristics* of the organization. The following diagram depicts these fraud exposures:

Management & Directors

Relationships with Others



Organization & Industry

Financial Results & Operating Characteristics

Although auditors have traditionally focused almost entirely on the financial statements and results of operations to detect financial statement fraud, each of these four areas present fraud exposures that must be examined. We now examine each of these four areas individually.

Management and the Board of Directors

As shown in the statistics presented previously, top management is almost always involved when financial statement fraud occurs. Unlike embezzlement and misappropriation, financial statement fraud is usually committed by the highest individuals in an organization, and most often on behalf of the organization as opposed to against the organization. Because management is usually involved, it is very important that management and the directors be examined to determine their exposure to, and motivation for, committing management fraud. Fraud is not committed by financial statements; rather, it is perpetrated by management or other top officers or directors. In detecting financial statement fraud, it is at least as important to gain an understanding of management and what motivates them than it is to understand the financial statements. In particular, it is important to examine three aspects of management:

1. Their backgrounds
2. Their motivations
3. Their influence in making decisions for the organization

With respect to *backgrounds*, it is important to gain an understanding of what kinds of organizations and situations management and directors have been associated with in the past. Examples of the kinds of questions that must be answered to fully understand management and director backgrounds are

- Are they new executives or directors?
- Did they work their way up within the organization or were they brought in from the outside?
- Have they been executives or directors in other organizations, and if so, what types of organizations?
- Have they had any previous regulatory or legal problems, either personally or with organizations they have been associated with?

An example of the importance of understanding management's background is Charles Keating and the Lincoln Savings and Loan fraud. Before perpetrating the Lincoln Savings and Loan fraud, Charles Keating was sanctioned by the Securities and Exchange Commission (SEC) for his involvement in a financial institution problem in Cincinnati, Ohio and, in fact, had signed a consent decree with the SEC that he would never again be involved in the management of another financial institution. He then had his real estate development company acquire Lincoln Savings and Loan that he allegedly used as his own personal piggy bank.

Another example where knowledge of background would have been helpful was CEO Robert Reed Rogers of Comparator Systems, the Los Angeles based fingerprint company accused of securities fraud in 1996. Rogers grew up in Chicago, he majored in chemistry in college, and became a college lecturer on business and economics. He worked short stints at the consulting firm McKinsey & Co. and Litton Industries. In information sent to investors, he boasted of many accomplishments, describing himself as founder and president of various companies developing products or processes. Missing from Rogers' biographical sketches is the fact that in the mid-70s, he was president of Newport International Metals. Newport was involved in the speculative rage of the period, precious metals. The company claimed to have the "exclusive right" to a certain mining process for producing jewelry. The company got \$50,000 in securities from investors John and Herta Minar of New York to serve as collateral to secure start-up funds, according to Orange County, California court records. Newport projected first year revenue of \$1.2 million. In 1976, Newport was cited by the state of California for unlawful sale of securities and was ordered to stop. The Minars sued and won a judgment for \$50,000. In 1985, they were still waiting for Rogers to pay; court records do not indicate if he ever did. In 1977, a bench warrant was issued for his arrest for failure to appear in court in connection with a lawsuit filed by investors in Westcliff International, another alleged mining concern, of which Rogers was president. In May 1978, he showed up for a hearing and the warrant was recalled. He was ordered to appear again on May 23 and did. The matter was settled; the outcome is not clear. Also in 1977, as general partner of Intermedico Community Health Care, Rogers and three others borrowed \$25,000 from Torrance, California lawyer William MacCabe. Three years later, MacCabe won a court judgment worth \$31,000. Certainly, Rogers had a tainted background that would have been helpful to auditors and others associated with Comparator Systems.

Regarding management and director *motivations*, it is important to understand what it is that really drives and motivates the organization's leaders. Is their personal worth tied up in the organization; are they under pressure to deliver unrealistic results; is their compensation primarily performance based; are there debt covenants or other financial measures that must be met; and is management's job at risk are examples of the kinds of questions that must be asked and answered to properly understand management's motivations. Many financial statement frauds have been perpetrated because management needed to report positive or high income to support stock prices, needed to show positive earnings for a public stock or debt offering, or needed to report profits to meet regulatory or loan restrictions.

Management's *ability to influence decisions* for the organization is important to understand because it is much easier to perpetrate management fraud when one or two individuals have primary decision making power than it is in an organization with a more democratic leadership. Most people who commit management fraud are first-time offenders and it is difficult to cross the line the first time and be dishonest. It is more difficult for two individuals to simultaneously be dishonest and even more difficult for three people to simultaneously be dishonest. When the decision-making ability is spread among several individuals, or when there is Board of Directors that takes an active role in the organization, fraud is much more difficult to perpetrate. Most financial statement frauds do not happen in large, historically-profitable organizations; rather, they occur in smaller organizations where one or two key individuals have almost total decision-making ability, and where there is an inactive Board of Directors and audit committee. An active Board of Directors and/or audit committee that gets involved in the major decisions of the organization can do much to deter management fraud.

Once management decides that it will commit fraud, the particular schemes used are usually determined by the nature of the business's operations. While we usually focus on the schemes and the financial results around those schemes, it is important to remember that the decision to commit fraud in the first place was management's or other officers'. The following chart summarizes the kinds of questions that must be asked about management and directors in examining fraud exposures.

Exercise 3-1

Analyzing Management and Directors to Determine Fraud Exposures

Understanding Management and Director Backgrounds

1. Have any of the key executives or Board Members been associated with other organizations in the past and what was the nature of those organizations and relationships?
2. Were key members of management promoted from within the organization or recruited from the outside?
3. Have any key members of management had past regulatory or legal problems, either personally or with organizations they have been associated with?
4. Have there been significant changes in the makeup of management or the Board of Directors?
5. Has there been a high turnover of management and/or Board members?
6. Do any members of management or the Board have criminal backgrounds?
7. Other issues related to the backgrounds of key members of management or the Board of Directors.

Understanding What Motivates Management and the Board of Directors

1. Are any of the key executives' personal worth tied up in the organization?
2. Is management under pressure to meet earnings or other financial expectations or does management commit to analysts, creditors, and others to achieve what appears to be unduly aggressive forecasts?
3. Is management's compensation primarily performance based (bonuses, stock options, etc.)?



4. Are there significant debt covenants or other financial restrictions that management must meet?
5. Is the job security of any key members of management at serious risk?
6. Is the organization's reported financial performance decreasing?
7. Is there an excessive interest by management in maintaining or increasing the entity's stock price?
8. Does management have an incentive to use inappropriate means to minimize reported earnings for tax reasons?
9. Other significant issues related to the motivations of management and Board members.

Understanding the Degree of Influence of Key Members of Management and/or the Board of Directors

1. Who are the key members of management and/or the Board of Directors who have the most influence?
2. Are there one or two key people who have dominate influence in the organization?
3. Is the management style of the organization more autocratic or democratic?
4. Is the organization's management centralized or decentralized?
5. Does management use ineffective means of communicating and supporting the entity's values or ethics, or do they communicate inappropriate values or ethics?
6. Does management fail to correct known reportable conditions in internal control on a timely basis?
7. Does management set unduly aggressive financial targets and expenditures for operating personnel?
8. Does management have too much involvement in or influence over the selection of accounting principles or the determination of significant estimates?
9. Other significant issues related to the degree of influence of key members of management and/or the Board of Directors.

Relationship with Others

Financial statement fraud is often perpetrated with the help of other real or fictitious organizations. Lincoln Savings and Loan, for example, structured sham transactions with certain straw buyers to make its negative performance appear profitable. A real estate limited partnership that committed financial statement fraud structured fraudulent transactions with bankers to hide mortgages on many of their real estate properties. Relationships with related parties are problematic because they often allow for other than arms-length transactions. The management of ESM Government, for example, hid a \$400 million financial statement fraud by creating a large receivable from a non-consolidated related entity.

While relationships with all parties should be examined to determine if they present management fraud opportunities or exposures, it is always important to carefully consider relationships with financial institutions, related organizations and individuals, external auditors, lawyers, investors, and regulators. Relationships with *financial institutions* are important because they provide an indication of the extent to which the company is leveraged.

Examples of the kinds of financial institution relationships that must be examined are

- Is the company highly leveraged and with which financial institutions?
- Which assets of the organization are pledged as collateral?
- Are there debt or other restrictions that must be met?
- Do the banking relationships appear normal or are there strange relationships with financial institutions such as using institutions in unusual geographical locations?
- Are there relationships between the officers of the financial institutions and your client organization?

The real estate partnership referred to earlier involved a Wisconsin Company taking out unauthorized loans from a bank located in another state, where it had no business purpose. The bank was used because the CEO of the client company had a relationship with the bank president, who later falsified an audit confirmation sent by the bank to the auditors. The loans were discovered when the auditors performed a lien search on properties owned. Because the bank president denied the existence of the loans, liabilities were significantly understated on the balance sheet.

Relationships with *related organizations and individuals* (related parties) should be examined because structuring non-arms-length, and often unrealistic, transactions with related organizations and individuals is one of the easiest ways to perpetrate financial statement fraud. These kinds of relationships are usually identified by examining large and/or unusual transactions, often occurring at strategic times (such as at the end of a period), to make the financial statements look better. The kinds of relationships that should be examined are

- Large transactions that result in revenues and/or income for the organization,
- Sales and/or purchases of assets between related entities,
- Transactions that result in goodwill or other intangible assets being recognized in the financial statements,
- Loans or other financing transactions between related entities, and
- Any transaction that appears to be unusual or questionable for the organization, especially transactions that are unrealistically large.

The relationship between a company and its *auditors* is important to analyze for several reasons. If there has been an auditor change, there is probably a good reason for the change. Auditing firms do not easily give up clients, and the termination of an auditor-auditee relationship is most often caused by failure of the client to pay, an auditor-auditee disagreement, suspected fraud or other problems by the auditor, or the auditee believing the auditor's fees are too high. While some of these reasons, such as high fees, may not signal a potential fraud problem, auditor-auditee disagreements, failure to pay an audit fee, and suspected problems can all be reasons that suggest a financial statement fraud problem. The fact that an auditor was dismissed or resigned, together with the difficulty of a first-year auditor to discover financial statement fraud, is cause for concern any time there is an auditor change.

Relationships with *lawyers* pose even greater risk than relationships with auditors. While auditors are supposed to be independent and must resign if they suspect that financial results may not be appropriate, lawyers are usually advocates for their clients, and will often follow and support their clients until it is extremely obvious that fraud has occurred. In addition, lawyers usually have information about a client's legal difficulties, regulatory problems, and other significant occurrences. Like auditors, lawyers rarely give up a profitable client unless there is something obviously wrong. Thus, a change in major legal firms without an obvious reason is often cause for concern. And, unlike auditors' changes, where a 10-K must be filed for public companies, there is no such reporting requirement with a change in lawyers.

Relationships with *investors* are important because financial statement fraud is often motivated by a debt or equity offering to investors. In addition, a knowledge of the number and kinds of investors (public vs. private company, major exchange vs. small exchange, etc.) can often provide an indication of the degree of pressure and public scrutiny upon the management of the company and its financial performance. If an organization is publically held, there are usually investor groups or investment analysts that follow the company very closely, and often can provide information or indications that something is wrong with the company. For example, "short" investors are always looking for bad news about an organization that will make its stock go down. If they suspect that something is not right, they will often contact management, or even the auditors (or press), to vent their concerns. Investor groups often focus on information very different from that used by auditors, and sometimes the fraud symptoms are more obvious to them than they are to auditors, especially auditors who focus only on the financial statements.

Finally, it is important to understand the client's relationship with *regulators*. If the company you are examining is a publically-held client, you need to know whether the Securities and Exchange Commission (SEC) has ever issued an enforcement release against them. You also need to know if all annual, quarterly, and other reports have been filed on a timely basis. If they are in a regulated industry such as banking, you need to know what their relationship is with appropriate regulatory bodies. Are there any problematic issues related to those bodies? It is also important to know whether the organization owes any back taxes to the federal or state government or to any other taxing district. Because of the recourse and sanctions available to taxing authorities, organizations usually do not fall behind on their payments unless something is wrong or the organization is having serious cash flow problems. The following table summarizes the kinds of questions that must be asked about a company's relationships with others.

Exercise 3-2 Relationships with Others

Relationships with Financial Institutions

1. What financial institutions does the organization have significant relationships with?
2. Is the organization highly leveraged through bank loans?
3. Are there loan or debt covenants or restrictions that pose significant problems for the organization?
4. Do the banking relationships appear normal or are there unusual attributes about the relationships (strange geographical locations, too many banks, etc.)?
5. Do members of management or the Board have personal or other close relationships with officers of any of the major banks used by the company?
6. Have there been significant changes in the financial institutions used by the company? If so, why?
7. Are there significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification?
8. Have critical assets of the company been pledged as collateral on risky loans?
9. Other questionable financial institution relationships.



Relationships with Related Parties

1. Are there significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm?
2. Are there large and/or unusual transactions at or near the end of a period that significantly improve the reported financial performance of the company?
3. Are there significant receivables and/or payables between related entities?
4. Has a significant amount of the organization's revenues and/or income been derived from related-party transactions?
5. Is a significant part of the company's income or revenues derived from one or two large transactions?
6. Other questionable related-party relationships.

Relationships with Auditors

1. Have there been frequent disputes with the current or predecessor auditors on accounting, auditing, or reporting matters?
2. Has management placed unreasonable demands on the auditor including unreasonable time constraints?
3. Has the company placed formal or informal restrictions on the auditor that inappropriately limit his/her access to people or information or his/her ability to communicate effectively with the Board of Directors or the Audit Committee?
4. Is there domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work?
5. Has there been an auditor change and for what reason?
6. Other questionable auditor relationships.

Relationships with Lawyers

1. Has there been significant litigation involving the company in matters that could severely and adversely effect the company's financial results?



2. Has there been an attempt to hide litigation from the auditors or others?
3. Has there been a change in outside counsels and for what reasons?
4. Other questionable lawyer relationships.

Relationships with Investors

1. Is the organization in the process of issuing an initial or secondary public debt or equity offering?
2. Are there any investor-related lawsuits?
3. Are there any problematic or questionable relationships with investment bankers, stock analysts or others?
4. Has there been significant “short selling” of the company’s stock and for what reasons?
5. Other questionable investor relationships.

Relationships with Regulatory Bodies

1. Does management display a significant disregard for regulatory authorities?
2. Has there been a history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws?
3. Have any 8-Ks been filed with the SEC and for what reasons?
4. Are there any new accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity?
5. Are there significant tax disputes with the IRS or other taxing authorities?
6. Is the company current on paying its payroll taxes and other payroll-related and other liabilities?
7. Other questionable relationships with regulatory bodies.

Organization and Industry

Financial statement fraud is sometimes masked by creating an organizational structure that makes it easy to hide fraud. For example, Lincoln Savings and Loan was a subsidiary of American National, which also had over 50 other subsidiaries and related companies. Lincoln, itself had several subsidiaries, some with no apparent business purpose. A significant part of the fraud was to structure supposedly “profitable” transactions near the end of each quarter by selling land to straw buyers. To entice the buyers to participate, the perpetrators often made the down payment themselves, by having Lincoln simultaneously loan the straw buyers the same amount (or more) money than they needed to make the down payments on the land. The simultaneous loan and purchase transactions were not easily identifiable because Lincoln would sell the land itself and have another related entity make the loan. What was really happening is that a complex organizational structure was being created that had no apparent business purpose, this was being used as “smoke” to hide illicit transactions. The same was true of ESM. In that case, related organizations were established to make it look like there were receivables due the company when, in fact, the related organizations were not audited and could not have paid even a small portion of the amount they supposedly owed. Attributes of an organization that present fraud exposures include such things as an unduly complex organizational structure, an organization without an internal audit department, a Board of Directors with no or few outsiders on the Board and/or audit committee, an organization where one or a small group of individuals control related entities, an organization that has off-shore entities with no apparent business purpose, and an organization that is new. It is extremely important that auditors and accountants really understand who the owners of an organization are. Sometimes there are silent or hidden owners that are using the organization in illegal or other questionable activities.

The COSO-sponsored study by Beasley, Carcello, and Hermansen concluded the following after studying the attributes of firms committing financial statement fraud:

- The relatively small size of fraud companies suggests that the inability or even unwillingness to implement cost-effective internal controls may be a factor effecting the likelihood of financial statement fraud (e.g., override of controls is easier). Smaller companies may be unable or unwilling to employ senior executives with sufficient financial reporting knowledge and experience.
- The importance of the organization’s control environment cannot be overstated, as emphasized in COSO’s *Internal Control - Integrated Framework* (COSO, 1992). Monitoring the pressures faced by senior executives (e.g., pressures from compensation plans, investment community expectations, etc.) is critical.
- The concentration of fraud among companies with under \$50 million in revenues and with generally weak audit committees highlights the importance of rigorous audit committee practices even for smaller organizations. In particular, the number of audit committee meetings per year and the financial expertise of the audit committee members may deserve closer attention.

- Investors should be aware of the possible complications arising from family relationships and from individuals (founders, CEO/board chairs, etc.) who hold significant power or incompatible job functions.

The industry of the organization must also be carefully examined. Some industries are much more risky than others. In addition, the organization's performance relative to that of similar organizations in the same industry must also be examined. The kinds of questions that should be asked in order to understand the exposure to management fraud because of organizational structure and industry are provided below.

Exercise 3-3 Organization and Industry

1. Does the company have an overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose?
2. Is there a legitimate business purpose for each separate entity of the business?
3. Is the Board of Directors comprised primarily of officers of the company or other related individuals?
4. Is there a passive or active, independent Board of Directors?
5. Is the audit committee comprised primarily of insiders or outsiders?
6. Is the audit committee passive or active and independent?
7. Does the organization have an independent and/or active internal audit department?
8. Does the organization have off-shore activities without any apparent business purpose?
9. Is the organization a new entity without a proven history?
10. Have there been significant, recent changes in the nature of the organization?
11. Is there adequate monitoring of significant controls?



12. Is there an effective accounting and information technology staff and organization?
13. Is there a high degree of competition or market saturation, accompanied by declining margins?
14. Is the client in a declining industry with increasing business failures and significant declines in customer demand?
15. Are there rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence?
16. Is the performance of the company similar or contrary to other firms in the industry?
17. Other significant issues related to organization and industry.

Financial Results and Operating Characteristics

Much can be learned about the exposure to financial statement fraud by closely examining management and the Board of Directors, relationships with others, and the nature of the organization. Looking at those three elements is always a good idea, but usually involves the same procedures for all kinds of financial statement frauds. What differs from fraud scheme to fraud scheme are the kinds of exposures identified by the financial statements and operating characteristics of the organization. In examining financial statements to assess fraud exposures, a non-traditional approach to the financial statements must be taken. Fraud symptoms most often exhibit themselves through *changes* in the financial statements. For example, financial statements that contain large changes in account balances from period to period are more likely to contain fraud than financial statements that exhibit only small, incremental changes in account balances. A sudden, dramatic increase in receivables, for example, is often a signal that something is wrong. In addition to changes in financial statement balances and amounts, it is very important to understand what the footnotes are really saying. I have seen frauds where the footnotes strongly hinted that fraud was occurring, but what was contained in the footnotes was not clearly understood by auditors and others.

In assessing fraud exposure through financial statements and operating characteristics, it is important to compare the balances and amounts with those of similar organizations in the same industry and to determine the real-world referents to the financial statement amounts. If, for example, an organization's financial statements state that the company has \$2 million of inventory, that inventory has to be located somewhere and, depending on the type of inventory it is, should require a certain amount of space to store it, lift forks and other equipment to move and ship it, and people to manage it. Are the financial statement numbers realistic given the actual inventory that is on hand?

Using financial statements to assess fraud exposures requires that you know the nature of the client's business, the kinds of accounts that should be included, the kinds of fraud that could occur in the organization, and the kinds of symptoms those frauds would generate. For example, the major activities of a manufacturing company could probably be subdivided into sales and collections, acquisition and payment, financing, payroll, and inventory and warehousing. I often find it helpful to break an organization down into various activities or cycles such as these and then, for each cycle, identify the major functions that are performed, the major risks inherent in each function, the kinds of abuse and fraud that could occur, and the kinds of symptoms those frauds would generate. I then use active detection techniques to determine if there is a likelihood of fraud in those cycles.

In the following discussions, we will focus primarily on financial performance and operating characteristics to detect financial statement fraud, with a segment on each major fraud type (such as revenue-related frauds, inventory frauds, etc.). While management, relationships, and organization exposures tend to be the same for all types of financial statement fraud, we will use an entire segment to identify the kinds of symptoms that result from various fraud schemes and constructive ways to detect such fraud.

Exercise 3-4

Financial Results and Operating Characteristic Exposures

1. Are there unrealistic changes or increases in financial statement account balances?
2. Are the account balances realistic given the nature, age, and size of the company?
3. Do actual physical assets exist in the amounts and values indicated on the financial statements?
4. Have there been significant changes in the nature of the organization's revenues or expenses?
5. Do one or a few large transactions account for a significant portion of any account balance or amount?
6. Are there significant transactions near the end of the period that positively impact results of operations, especially transactions that are unusual, highly complex or that pose "substance over form" questions?
7. Do financial results appear consistent on a quarter-by-quarter or month-by-month basis or are there unrealistic amounts in a sub-period?



8. Is there an inability to generate cash flows from operations while reporting earnings and earnings growth?
9. Is there significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity – including need for funds to finance major research and development or capital expenditures?
10. Are reported assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgements or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity – such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs?
11. Is there an unusually rapid growth or profitability, especially compared with that of other companies in the same industry?
12. Is the organization highly vulnerable to changes in interest rates?
13. Are there unrealistically aggressive sales or profitability incentive programs?
14. Is there a threat of imminent bankruptcy or foreclosure, or hostile takeover?
15. Is there a high possibility of adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported?
16. Is there a poor or deteriorating financial position when management has personally guaranteed significant debts of the entity?
17. Does the firm continuously operate on a “crisis” basis or without a careful budgeting and planning process?
18. Does the organization have difficulty collecting receivables or have other cash flow problems?
19. Is the organization dependent on one or two key products or services, especially products or services that can become quickly obsolete or where other organizations have the ability to adapt more quickly to market swings?



20. Do the footnotes contain information about difficult-to-understand issues?
21. Are there adequate disclosures in the footnotes?
22. Other questionable or suspicious factors relating to financial results or operating characteristics.

Importance of Context When Using Red Flags to Detect Fraud

When using red flags to detect fraud, it is very important to understand context. While we will present lists of questions (red flags) that should be considered in each of the four categories (management, relationships, organization, and operating results), you should understand that simply answering yes or no to these kinds of questions in considering the possibility of management fraud may not help in identifying or detecting such fraud. In fact, there is a growing body of academic research that has found that when auditors use red flag checklists (like those presented in the SAS 53 and SAS 82) without considering context, they may even be less likely to detect financial statement fraud than if they used no checklists at all. For several years, audit policy with respect to fraud detection has focused the auditor on red flag cues that can be used to predict the likelihood of fraud. Practitioners have generally implemented these standards by generating fraud checklists that auditors use to consider these cues (Shelton, Whittington and Landsittel 2001). Both Pincus (1989) and Asare and Wright (2002) studied the effects of fraud checklists on risk assessments. In these studies, an actual fraud case was used and checklist usage was manipulated between subjects. Somewhat surprisingly, results show that auditors who use a fraud checklist are less sensitive to the presence of fraud when compared with auditors who do not use a checklist. Asare and Wright (2002) suggest that this may occur because an unorganized, generic fraud checklist may keep auditors from developing a “coherent story” when assessing fraud risk. They argue that, for this reason, checklist use may result in a lower level of cognitive processing. The results of these two studies may also suggest that checklist use may prevent auditors from reasoning strategically. Specifically, while the cues in a fraud checklist may help auditors engage in first-order reasoning, humans have cognitive limitations that make it difficult for them to put themselves in the shoes of the auditee when simply reviewing a laundry list of cues.

Wilkes and Zimbelman (2002) suggest that fraud theory may provide a potential solution to the checklist problem. As you have learned in this book, fraud theory explains fraud as the interaction of three causal influences—pressure, opportunity, and rationalization—affecting a potential perpetrator. Wilkes and Zimbelman suggest that perhaps if fraud checklists were to incorporate this categorization (as suggested by the recently proposed revision to *SAS No. 82*), auditors would be better able to assimilate all important cues. Moreover, because of the reduced cognitive strain resulting from categorizing fraud risk cues according to incentives, opportunities, and attitude, auditors may improve their ability to reason strategically about how management will behave.

It is because of research such as this that the new auditing exposure draft on fraud emphasizes the fraud triangle as a context in which to understand fraud.

Here are the references if you want them:

(Pincus, K. 1989. The efficacy of a red flags questionnaire for assessing the possibility of fraud. *Accounting, Organizations, and Society* 14: 153-163. Shelton, S. W., O. R. Whittington, and D. Landsittel. 2001. Auditing firms' fraud risk assessment practices. *Accounting Horizons*, March: 19-33. Asare, S. and A. Wright. 2002. The impact of risk checklists and standard audit programs on the planning of fraud detection procedures. *Working paper*. University of Florida. "Academic Research and Auditors' Detection of Fraudulent Financial Reporting: Audit Policy Implications.," T. Jeffrey Wilks and Mark F. Zimbelman, working paper presented at the University of Kansas Audit Symposium, May, 2002.)

Steps 2 (Understanding the Kinds of Symptoms These Fraud Exposures Would Exhibit), 3 (Using Various Kinds of Analyses to Proactively Look for Relevant Symptoms), and 4 (Following up on Symptoms Observed to Determine Whether the Symptoms Related to Fraud or Are Occurring Because of Some Other Reason)

Thus far in this segment, we have covered the first step in detecting financial statement fraud – identifying fraud exposures. The reason we went into so much detail about that step is because much of the approach to identifying fraud exposures is similar, regardless of the type of organization you are dealing with or the specific fraud scheme of concern. Fraud schemes are chosen by perpetrators more often because of their “ease to commit and conceal” than by any other factor. While it is the exposures we have discussed thus far that often motivate fraud, most fraud symptoms, especially those relating to financial results and operating characteristics, are scheme-specific. Thus, we will not discuss specific types of fraud symptoms, but rather, we will organize the remaining segments according to type of fraud scheme, focusing on

- Revenue and receivable financial statement frauds,
- Inventory and cost of goods sold financial statement frauds,
- Financial statement frauds involving liabilities,
- Financial statement frauds involving the overstatement of assets (other than receivables and inventory), and
- Frauds involving inadequate disclosures.

For each of these various types of fraud schemes, we will discuss scheme-specific fraud exposures, symptoms that indicate that fraud may be occurring, steps and analyses that can be taken and/or used to search for fraud symptoms, and ways to follow up on symptoms observed to determine whether they relate to fraud or are occurring because of some other reason.