Quantifying the Quality of Financial Statement and When There May Be Fraud

Speaker Introduction

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Agenda

- Financial Statement Reporting and Analysis
- Fraud Considerations
- Examples of Frauds and Possible Red Flags

Financial Statement Reporting and Analysis

Financial Statement Reporting:

A complete set of financial statements

Set of financial statements

Statement	Description
Balance sheet	• Shows the financial position (assets and liabilities) of the company at the end of the period
Income statement	• Shows the results of the operations for the period
Statement of cash flows	• Shows cash inflows (receipts) and outflows (uses) for the period
Statement of owners' or stockholders' equity	• Explains investments by and distributions to owners during the period
Notes to the financial statements	• Provides qualitative data

Objectives of Financial Statement Reporting

"…intended to provide information that is useful in making business and economic decisions."

Provide useful information in:

- Investment and credit decisions
- Assessing cash flow prospects

Provide useful information about:

- Enterprise resources, claims to those resources, and changes in the resources
- Economic resources, obligations, and owners' equity
- Enterprise performance and earnings
- Liquidity, solvency, and funds flows

Financial Ratio Analysis

Financial ratios are commonly used for trend analysis and comparisons to other competitors.

Types of ratios include:

Profitability ratios: A primary measure of the overall success of a company.

Liquidity ratios: Measures a company's ability to meet currently maturing debts.

Leverage ratios: Measures a company's ability to meet long-term financial obligations on a continuing basis.

Efficient ratios: Measures a company's ability to efficiently manage its assets and liabilities.

Key things to look for on the Balance Sheet

- How liquid are the assets?
- What is the underlying nature of the assets?
- How leveraged is the company?
- Can they meet their current obligations?
- What is the breakdown between short-term and long-term debt?
- What is the quality of the assets? (e.g., collectability of receivables)

Key things to look for on the Income Statement

- Is the company profitable?
- What portion of the income is from non-recurring/non-operating transactions?
- Which expense items seem out of line?
- How do operations and performance results compare to:
  - Previous years (vertical and horizontal analysis)
  - Competitors / Industry

Income Statement

	Properly Stated			Misstated	
Revenues	$ 412,800			$ 427,085	
Cost of Goods Sold	200,000			180,000	
Gross Margin	212,800			247,085	
Operating Expenses:			52%		58%
Sales, General & Administrative Expenses	70,000			70,000	
Restructuring Charges	29,400			49,400	
Depreciation and Amortization	6,400			6,400	
Bad Debt Expense	600			600	
Income from Continuing Operations	106,400			120,685	
Other Gains / (Losses):			26%		28%
Income from Equity Investments	100			100	
Interest Expense	(2,000)			(2,000)	
Income from continuing operations before taxes, extraordinary item and effect of change in accounting principle	104,500			118,785	
Provision for Income Taxes (30%)	31,350			35,636	
Income from continuing operations before extraordinary item and effect of change in accounting principle	73,150			83,150	
Loss on Discontinued Operations, net of tax	(60,000)			(60,000)	
Gain on Extraordinary Item, net of tax	10,000			-	
Less: Net Income Attributable to the Non Controlling Interest	5,000			5,000	
Effect of change in Accounting Principle, net of tax	-			-	
Net Income	$ 28,150			$ 28,150	

Key things to look for on the Cash Flow Statement

- Does the company have positive cash flow?
- Did the company's cash position change significantly?
- How is the company using its cash?
- What were the sources of the company's funds?
- Comparison on Income Statement to Cash Flow Statement:
  - Strong income from continuing operations versus weak cash flow provided by operating activities
- Assess the ability of the company to meet its obligation, pay dividends, need for external financing

Fraud Considerations

What is Fraud?

"The knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment and a misrepresentation made recklessly without belief in its truth to induce another to act."

– Black's Law Dictionary

"Any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises."

– Mail Fraud Statute

"The crime of using dishonest methods to take something of value from another person."

– Merriam-Webster Dictionary

"The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." – Association of Certified Fraud Examiners

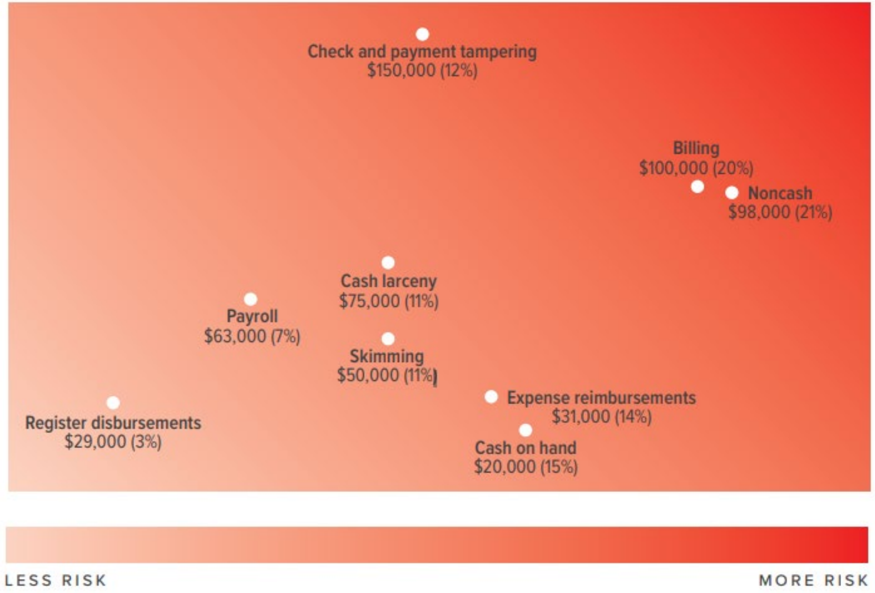
Risk of Fraud is Real

- Fraud is usually concealed.
- Fraud is very difficult to detect just by looking at financial statements.
- Fraud doesn't just happen to other companies.
- Fraud cuts across industries and businesses.
- Trusted insiders and external vendors often involved.
- Federal, state and local law enforcement are prepared to investigate and prosecute.
- Impact of fraud can be lasting. Thus, fraud awareness, detection, and prevention are critical.
- Every level of management, staff, and internal auditors are responsible for managing fraud risk.

Construction	Supply Chain
Engineering	Electric Operations
Energy Services	Customer Operations

How is Fraud Committed?

What asset misappropriation schemes present the greatest risk?



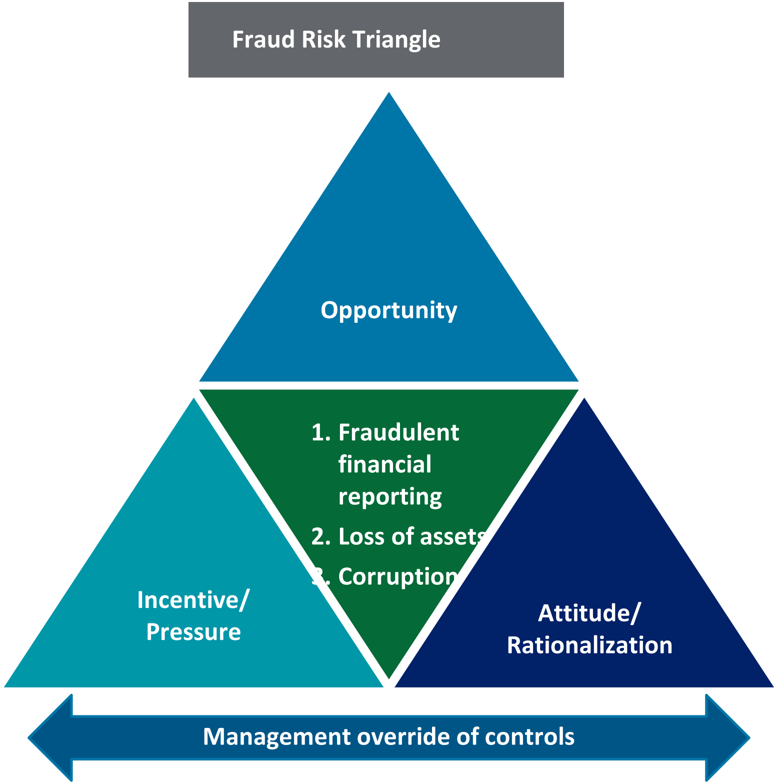
Source: Association of Certified Fraud Examiners (ACFE) Report to the Nations 2018 Global Study on Occupational Fraud and Abuse

Fraud Facts

- **Tips** are the most common initial detection method (40%), followed by internal audit (15%) and management review (13%)
- **Employees** provide over half of tips
- **Internal Controls Weaknesses** were responsible for nearly half the frauds
- **53%** of victim organizations have not recovered any of their losses due to fraud
- **5%** of an organization’s annual revenue is typically lost to fraud
- Median losses are far greater when fraudsters collude
- Median duration of a fraud scheme is 16 months
- **Only 4%** of perpetrators had prior convictions

Source: Association of Certified Fraud Examiners (ACFE) Report to the Nations 2018 Global Study on Occupational Fraud and Abuse

COSO Framework Principle 8: Assessing the Risk of Fraud



The **Fraud Risk Triangle** displays:

Factors impacting fraud risk:

- Incentives and pressures
- Opportunity
- Attitudes and rationalizations

Types of fraud

- Fraudulent financial reporting
- Fraudulent nonfinancial reporting
- Possible loss of assets (misappropriation)
- Corruption

Management override of controls

The ability of those charged with governance to commit fraud by overriding controls that might otherwise appear to be operating effectively.

Six Symptoms of Fraud

01
Behavioral Symptoms

- Unusually close association with vendors
- Unwillingness to share duties
- Recent divorce or family problems

02
Accounting Anomalies

- Timing differences between collections and posting to accounts
- Credits to a customer account followed by an identical debit

03
Analytical Anomalies

- Unexplained change in uncollectable accounts and aging
- Increases in credit level inconsistent with sales volume
- Unusual number of credit or pricing overrides

04
Lifestyle Symptoms

- Living beyond one's means
- Social isolation

05
Internal Control Symptoms

- Inadequate anti-fraud controls, including employee training
- Poor tone at the top
- Lack of segregation of duties; lack of independent checks/audits

06
Tips and Complaints

- Absence of whistleblower policy/fraud hotline information

Why Commit Fraud?

- Smoothing earnings / meeting expectations (e.g., Wall Street, investors, debt covenants)
- Achieving compliance with contractual terms (e.g., debt covenants)
- Facilitate the use of non-GAAP earnings (e.g., EBITDA)
- Meet bonus targets, compensation incentives, etc.
- Increase value of stock-based compensation
- Personal financial pressures
- Internal pressures to meet financial or other targets set by headquarters
- Corrupt corporate culture

Some Reasons Why Fraud is Hard to Identify

- **Loss of skeptical outlook** - Reliance on current or historical relationship, trust those you work with, thereby potentially missing signs of possible fraud
- **Too narrowly focused** - May not consider if things make sense from a broader perspective
- **Avoid conflict with people** - Feel a need to be liked by others
- **Employees are not prepared for or experienced in dealing with fraud** – Compounded by other factors like inconsistent management oversight or possible lack of professionalism
- **Too many jobs running at one time** - pressure to complete tasks
- **Don't recognize pressures or opportunities** - the macro level of the company that could result in possible fraud; lack understanding of business processes
- **Warning signs may not be adequately recognized** - changes in personality, personal issues, pressure to perform, etc.

Professional skepticism, as defined by Auditing Standard 316.13, is "an attitude that includes a questioning mind and a critical assessment of audit evidence."

Examples of Fraud Schemes and Possible Red Flags

Common Areas of Fraud Risk