INDICATORS OF ACCOUNTING MANIPULATIONS

Hrvoje Katunar, *PhD student, University of Rijeka, Faculty of Economics*
Siniša Bubek, *PhD student, University of Rijeka, Faculty of Economics*
Davor Mance, *PhD student, University of Rijeka, Faculty of Economics*

1. INTRODUCTION

The paper discusses the reasons for manipulating information in financial statements of companies, as well as the indicators that serve as warning signs of the possibility of fraud and to witch increased attention should be paid during the audit of financial statements. The manipulation of financial reports is especially present in times of significant growth in the general economy and within the companies that cannot keep track of the growth of their regular business, and in times of recession and crisis with the aim of "cleaning" the financial statements, the balance-sheet positions burdened in times of growth. The objective is to capture a favourable position in face of a wave of increased economic activity. Manipulations of financial statements are especially present in companies where financial receipts and bonuses to management directly depend upon the results of operations. Manipulation in greater numbers is reported with the liberalization of accounting principles and policies, and with the introduction of the accounting principle of fair value. It should be noted that the occurrence of these indicators does not necessarily prove fraud, but they provide adequate signs of warning for fraudulent behaviour.

2. THE TERM AND THE GOALS OF ACCOUNTING MANIPULATION

The term manipulation is complex and it is very difficult to find a single definition of manipulation. Manipulation is commonly defined as "any intentional act or omission designed to deceive others, that results in losses to third persons i.e. the victims of manipulation". [1] Manipulation with the aim of fraud is considered to be any false reporting in order for someone else to lose its money. One of the basic and most important concepts in the field of detecting fraud is known as the "Fraud triangle". [2] The set hypothesis claims that the motive (purpose), opportunity and self-justification are "key elements of fraud of which the most important to prove is the motive, that is the intention that makes the difference between error and fraud. As a version of the word fraud the following phrases are commonly used: deliberately faking, deceitfulness, cheating, lying, embezzlement, fraud. Basic categories of fraud are: fraudulent financial reporting, illegal appropriation of assets, and corruption. [3]

Fraudulent financial reporting includes three basic types of fraud. Its implementation needs an "adjustment" of the financial statements. It can be classified in regard of the affected parties, as follows:

- Fraud of the State in favour of the company and its shareholders;
- Fraud of the company and its shareholders, in favour of the individual;
- Fraud of the company, its shareholders and the State in favour of the individual.

Although the companies have developed elaborate systems of controlling, which help to ensure accurate, precise and prompt monitoring of accounting procedures and proper application of accounting standards, such systems only help prevent random errors in

accounting. However, individuals that deliberately and consciously manipulate the financial statements in an attempt to circumvent accounting procedures and at the same time cover up their actions are very difficult to discover by this automated systems of controlling. At the same time a lack of evidence makes the individuals that are manipulating financial statements with the purpose of fraud very difficult to prevent, detect and stop. The basic requirement for stopping fraudulent financial reporting is detection. During the detection of manipulation with fraudulent purposes 34.2% of all discoveries are made by a tip; 25.4% are coincidental; and 55.2% are found by internal and external audits, internal controls and police. [4] Some manipulations are discovered by multiple sources which is why the total sum exceeds 100%.

3. REASONS THAT LEAD TO ACCOUNTING MANIPULATION

A SEC study [5] conducted in 2007 showed that the primary reason for committing fraud are pressures to do "whatever is necessary" to achieve the goals at 80% of respondents, while the achievement of personal goals is given as a reason for fraud at 72% of respondents. The most common forms of financial statement fraud, according to a study by Deloitte arise from inappropriate recognition of revenue (41%), irregular notes (12%), manipulation costs (11%), manipulation of property (7%), manipulation obligations (7%), manipulation of reserves (7%), illegal appropriation of property (4%), bribery (3%), incitement to criminal acts (2%), fraudulent financial reporting expressed in the area of goodwill (1%) and investments (1%). The most common cases of manipulation of income with the goal to commit fraud cover 70% of all cases of fraudulent financial reporting. Most often fraudulent financial reporting is showing fictive income (123 cases - 35%). In addition, a significant portion of fraudulent financial reporting stems from inappropriate recognition of revenue from swaps, the recognition of revenue from sales where the sales invoiced, but not shipped goods and so on. Furthermore, such cases of fraud are classified when they are recognized in revenue even though all activities related to the transaction have not been settled, which means that they recognized revenues when products and services were not provided, the delivery was not made, or the buyer did not receive the goods.

In financial reporting usually seven basic manipulations of financial statements can be identified. All seven basic types of manipulations of financial results are: [6]

1. Too early record of revenue, and/or of questionable quality;
2. Recording of bogus revenue;
3. Boosting revenue with one-time gains;
4. Shifting current expenses to a later or earlier period;
5. Failure to record or improperly reduce liabilities;
6. Shifting current revenues to a later period;
7. Shifting future expenses to a current period.

The basic motives for the use of accounting manipulation can be classified into two basic categories that follow:

- maximisation of financial results by stating enlarged income and/or less expenses;
- minimisation of financial results (and shifting them to a future period) by stating less income and enlarged expenses.

The aim of the strategy of increasing financial results is to increase the value of the company in the financial markets, and in order to increase the wealth of individuals through various incentives within the company (such as bonuses). The aim of the strategy of decreasing financial results is to shift the profit to a later period, when it is needed.

4. INDICATORS OF MANIPULATION AND FRAUDULENT CONDUCT

Financial reports can be audited using a vertical and horizontal analysis and by reviewing the notes adjacent to the financial statements. Indicators, which usually indicate dodgy companies, can be classified according to a particular financial report (balance sheet, report on cash flows and notes). The indicators and the problems that they cause are listed in the following tables. [6]

Table 1

Balance Sheet and Statement of Operations

Warning Sign	Problem indicated or Shenanigan Used
1. Cash and equivalents decline relative to total assets	Liquidity issues; may need to borrow
2. Receivables grow substantially faster than sales	Perhaps aggressive revenue recognition-recording revenue too soon or granting extended credit terms to customers
3. Receivables grow substantially slower than sales	Receivables may have been reclassified as another asset category
4. Bad debt reserves decline relative to gross receivables	Understanding and inflating operating income
5. Unbilled receivables grow faster than sales or billed receivables	A greater portion of revenue may be coming from sales under the percentage-of-completion method
6. Inventory grows substantially faster than sales, cost of sales, or accounts payable	Inventory may be obsolete requiring a write-off; company may have failed to charge the cost of sales on some sales
7. Inventory reserves decline relative to inventory	Under-reserving and inflating operating income
8. Prepaid expenses shoot up relative to total assets	Perhaps improperly capitalizing certain operating expenses
9. Other assets rise relative to total assets	Perhaps improperly capitalizing certain operating expenses
10. Gross plant and equipment increases sharply relative to total assets	Perhaps capitalizing maintenance and repair expense
11. Gross plant and equipment declines sharply relative to total assets	Failing to invest in new plant and equipment
12. Accumulated depreciation declines as gross plant and equipment rises	Failing to take sufficient depreciation charge-inflating operation income

13. Goodwill rises sharply relative to total assets	Perhaps tangible assets were reclassified to goodwill to avoid expensing them in future periods
14. Accumulated amortization declines as goodwill rises	Failing to take sufficient amortization charge-inflating operating income
15. Growth in accounts payable substantially exceeds revenue growth	Failed to pay off current debts for inventory and supplies-will require larger cash outflow in future period
16. Accrued expenses decline relative to total asset	Perhaps company released reserves-inflating operating income
17. Deferred revenue declines while revenue increases	Either new business is slowing or company released some reserves to inflate revenue
18. Cost of goods sold grows rapidly relative to sales	Pricing pressure results in lower gross margins
19. Cost of goods sold declines relative to sales	Company may have failed to transfer the entire cost of the product from inventory
20. Cost of goods sold fluctuates widely from quarter to quarter relative to sales	Unstable gross margin could indicate accounting irregularities
21. Operating expenses decline sharply relative to sales	Perhaps improperly capitalizing certain operating expenses
22. Operating expenses rise significantly relative to sales	Company may have become less efficient, spending more for each unit sold
23. Major portion of pretax incomes comes from one-time	Core business may be weakening
24. Interest expense rises materially relative to long-term debt	Higher cash outflow expected
25. Interest expense declines materially relative to long-term debt	Perhaps improperly capitalizing certain operating expenses
26. Amortization software costs grow more slowly than capitalized costs.	Perhaps improperly capitalizing certain operating expenses

Table 2
Statement of Cash Flows

Warning Sign	Problem Indicated or Shenanigan Used
1. CFFO materially lags behind net income	Quality of earnings may be suspect or expenditures for working capital may have been to hide
2. Company fails to disclose details of cash flow from operations	Company may be trying to hide the source of its operating cash problem
3. Cash inflows come primarily from asset sales, borrowing, or equity offerings	Signs of weakness, especially if cash comes exclusively from asset sales, borrowing, or equity offerings

Table 3
Footnotes, Management Comments, Auditors Letter

Warning Sign	Problem Indicated or Shenanigan Used
1. Change in accounting principle	Attempt to hide an operating problem
2. Change in accounting estimate	Attempt to hide an operating problem
3. Change in accounting classification	Attempt to hide an operating problem
4. Change in auditor	Sign of risky client
5. Change in CFO or outside counsel	Sign of risky client
6. Investigation by the SEC	Could lead to accounting restatements
7. Long-term commitments	Potentially large drain on cash reserves
8. Current or potential litigation	Potentially large drain on cash reserves
9. Liberal accounting policies	Financial reports may inflate profits
10. Misguided management incentives	May lead to some financial shenanigans to boost profits, bonuses, and share prices
11. Weak control environment	Creates easy opportunities to perpetrate financial shenanigans
12. Auditors concern	Sign of risky client
13. Promotional management	May be more likely to use financial shenanigans than modes executives
14. Use of percentage of completion accounting	Revenue may be inflated
15. Use of bill and hold accounting	Revenue may be inflated
16. Overreliance on few customers	Potential business problem if one of them leaves
17. Financial problems at key customer	Business can be hurt if a key customer files for bankruptcy
18. Seller finances customer	Revenue may be inflated and business may be much weaker than you realized
19. Customer has right of return	Revenue may have been recorded too soon
20. Barter transaction	Revenue may have been inflated
21. Seller gives customer stock warrants	Revenue may have been inflated
22. Capitalized interest of software	Operating income may be inflated
23. Unrecorded liabilities, such as stock options	Future cash obligations may be greater than expected and operating income may be inflated
24. Noncompliance with debt covenant	Bank may call loan, causing a substantial cash crunch
25. Absence of unaffiliated directors on board	Weak control environment may create opportunities for management to perpetrate financial shenanigans
26. Prepayment of future periods operating expenses	Leads to inflated operating income in future periods

The occurrence of individual financial statement manipulation indicators does not necessarily mean that fraud has been committed; however, it gives a warning of possible manipulations which allows auditors to make a detailed audit in search of the cause of the change in the financial statements position. Each of these indicators may originate from operating activities or fraudulent behaviour. Changes caused by regular operating activities lead to equalized cause-related changes in the financial statements while manipulative behaviour with great difficulty manages to harmonize the overall financial statements.

5. CONCLUSION

The paper discusses the reasons for manipulative behaviour visible through the financial statements of companies, as well as the indicators that give warning of the possibility of fraud and increased caution while controlling company's books and financial statements. Financial statement manipulations are especially present in companies where there are direct incentives to do so i.e. where management remunerations directly depend on the results of operations. Manipulation with the aim of fraud is considered to be any act of false reporting where there is any financial or material loss inflicted to third parties. Fraudulent financial reporting consists of three basic types of fraud, classified by the affected parties: the state, the shareholders and the company itself. Despite the systems of controls, individuals which are deliberately and consciously manipulating the financial statements, and/or are trying to circumvent the procedure and at the same time cover up their actions are very difficult to detect by any of the automated systems of controlling.

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