INTRODUCTION TO FINANCIAL STATEMENTS & FINANCIAL STATEMENT FRAUD


CHEVROLET CHEVROLET CHEVROLET CHEVROLET
TOTAL
WICKETS
OVERS
BATSMAN
BATSMAN
PARTNERSHIP
RUNS TO WIN
OVERS LEFT
RATE ACH'D
RATE REQ'D
CHEVROLET CHEVROLET CHEVROLET CHEVROLET
xxess DSL
Coca-Cola
xxess DSL
xxess DSL

SPORTS WITHOUT SCOREBOARD??

FINANCIAL STATEMENTS

- A **financial statement** (or **financial** report) is a formal record of the **financial** activities and position of a business, person, or other entity. Relevant **financial** information is presented in a structured manner and in a form easy to understand.
- General purpose financial statements (referred to as ‘financial statements’) are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

FINANCIAL STATEMENTS

- As per companies Act 2013 financial statements includes :

1. Balance Sheet
2. Profit & Loss Account/ Income & Expenditure Account(In case of not for profit organizations)
3. Statement of Changes in Equity (If Applicable)
4. Cash Flow Statement (If Applicable)
5. Notes annexed there too.

FINANCIAL STATEMENTS

- BALANCE SHEET (WEALTH)

  Statement of Assets, Liabilities & Capital at a particular point of time. It can also be called as summery stating sources & application of funds.

- PROFIT & LOSS ACCOUNT (EARNINGS)

  Summery of Income & Expenditure during a particular period.

FINANCIAL STATEMENTS

- CASH FLOW STATEMENT

  Segregating cash flow in to Operating, Investment & Financing activities.

- STATEMENT OF CHANGES IN EQUITY

  Statement showing any fluctuation in owners of a company.

- NOTES TO ACCOUNTS

  Explanatory part of Balance Sheet and Profit & Loss Accounts.

IMPORTANCE

- Communicates financial position to outside world.
- Acts as an Primary tool for Investment decision.
- Taxes paid to government are dependent on accuracy of financial statements.

USERS OF FINANCIAL STATEMENTS

- OWNERS (SHAREHOLDERS)
- LENDERS
- EMPLOYEES
- GOVERNMENT
- CUSTOMERS
- SUPPLIERS
- SOCIETY

HOW TO READ FINANCIAL STATEMENTS

- VERTICAL READING
  - Commonsize Statement
- HORIZONTAL READING
  - Comparative Statement
  - Trend Analysis

Balance Sheets

(₹ in Thousands)	A	B	C
ASSETS			
Cash, cash equivalents, marketable securities	3800	400	6600
Accounts receivable	1000	2100	3000
Inventory	200	1900	600
Total current assets	**5000**	**4400**	**10200**
Property, plant, and equipment (net)	1500	1500	9300
Goodwill	0	600	0
Total assets	**6500**	**6500**	**19500**
LIABILITIES AND EQUITY			
Accounts payable	0	5000	1200
Total current liabilities	**0**	**5000**	**1200**
Long-term bonds payable	20	20	18000
Total liabilities	**20**	**5020**	**19200**
Total shareholders equity	6480	1480	300
Total liabilities and shareholders equity	**6500**	**6500**	**19500**

Common-size Balance Sheets			
(₹ in Thousands)	**A**	**B**	**C**
ASSETS			
Cash, cash equivalents, marketable securities	58.46%	6.15%	33.85%
Accounts receivable	15.38%	32.31%	15.38%
Inventory	3.08%	29.23%	3.08%
Total current assets	**76.92%**	**67.69%**	**52.31%**
Property, plant, and equipment, net	23.08%	23.08%	47.69%
Goodwill	0.00%	9.23%	0.00%
Total assets	**100.00%**	**100.00%**	**100.00%**
LIABILITIES AND EQUITY			
Accounts payable	0.00%	76.92%	6.15%
Total current liabilities	**0.00%**	**76.92%**	**6.15%**
Long-term bonds payable	0.31%	0.31%	92.31%
Total liabilities	**0.31%**	**77.23%**	**98.46%**
Total shareholders equity	99.69%	22.77%	1.54%
Total liabilities and shareholders equity	**100.00%**	**100.00%**	**100.00%**

Profit & Loss Account

Particulars	(₹ in Lakhs)			
	Company A		**Company B**	
	2013	**2014**	**2013**	**2014**
Net Sales	2000	2200	1000	1500
Less: Cost of sales	1600	1700	800	1000
Gross Margin	**400**	**500**	**200**	**500**
Operating Expenses	200	250	150	300
Net Profit before Tax	**200**	**250**	**50**	**200**

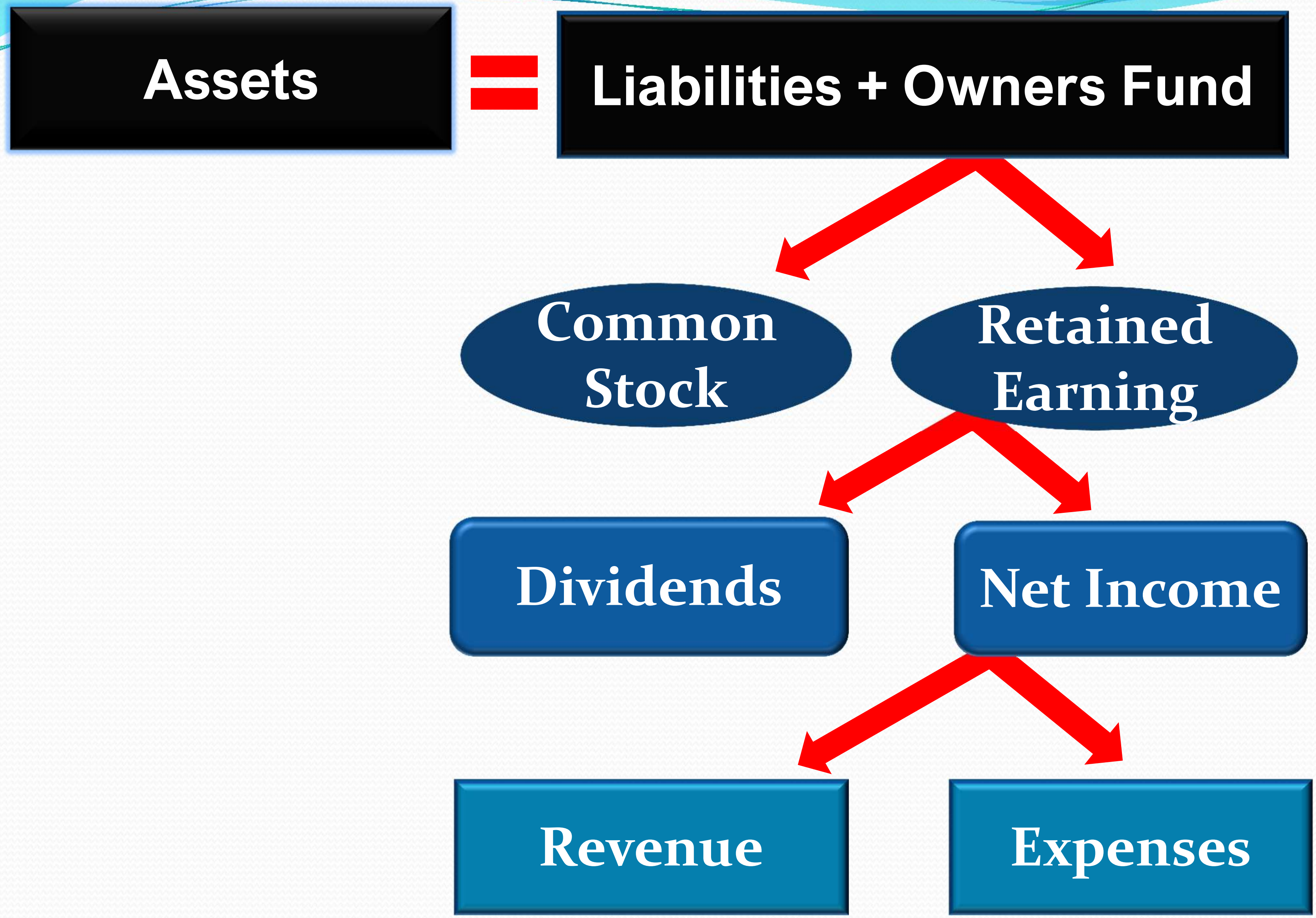
Comparative Profit & Loss Account

(₹ in Thousands)

Particulars	Company A				Company B			
	2013	2014	Increase/ (Decrease) ₹	Increase/ (Decrease) %	2013	2014	Increase/ (Decrease) ₹	Increase/ (Decrease) %
Net Sales	2000	2200	200	10.00%	1000	1500	500	50.00%
Less: Cost of sales	1600	1700	100	6.25%	800	1000	200	25.00%
Gross Margin	**400**	**500**	**100**	**25.00%**	**200**	**500**	**300**	**250.00%**
Operating Expenses	200	250	50	25.00%	150	300	150	100.00%
Net Profit before Tax	**200**	**250**	**50**	**25.00%**	**50**	**200**	**150**	**300.00%**

Balance Sheets			
(₹ in Thousands)	**2013**	**2014**	**2015**
ASSETS			
Cash, cash equivalents, marketable securities	1000	1400	2000
Accounts receivable	700	800	600
Inventory	200	300	600
Total current assets	**1900**	**2500**	**3200**
Property, plant, and equipment, net	2000	2000	7000
Goodwill	100	200	200
Total assets	**4000**	**4700**	**10400**
LIABILITIES AND EQUITY			
Accounts payable	3000	2700	4000
Total current liabilities	**3000**	**2700**	**4000**
Long-term bonds payable	100	100	100
Total liabilities	**3100**	**2800**	**4100**
Total shareholders equity	900	1900	6300
Total liabilities and shareholders equity	**4000**	**4700**	**10400**

Trend Analysis Balance Sheets						
Particulars	**(₹ in Thousands)**			**Trend (%)**		
	2013	**2014**	**2015**	**2013**	**2014**	**2015**
ASSETS						
Cash, cash equivalents, marketable securities	1000	1400	2000	100.00%	140.00%	200.00%
Accounts receivable	700	800	600	100.00%	114.29%	85.71%
Inventory	200	300	600	100.00%	150.00%	300.00%
Total current assets	**1900**	**2500**	**3200**	**100.00%**	**131.58%**	**168.42%**
Property, plant, and equipment, net	2000	2000	7000	100.00%	100.00%	350.00%
Goodwill	100	200	200	100.00%	200.00%	200.00%
Total assets	**4000**	**4700**	**10400**	**100.00%**	**117.50%**	**260.00%**
LIABILITIES AND EQUITY						
Accounts payable	3000	2700	4000	100.00%	90.00%	133.33%
Total current liabilities	**3000**	**2700**	**4000**	**100.00%**	**90.00%**	**133.33%**
Long-term bonds payable	100	100	100	100.00%	100.00%	100.00%
Total liabilities	**3100**	**2800**	**4100**	**100.00%**	**90.32%**	**132.26%**
Total shareholders equity	900	1900	6300	100.00%	211.11%	700.00%
Total liabilities and shareholders equity	**4000**	**4700**	**10400**	**100.00%**	**117.50%**	**260.00%**


Assets
Liabilities + Owners Fund
Common Stock
Retained Earning
Dividends
Net Income
Revenue
Expenses

FINANCIAL STETEMENT FRAUD (FSF)

- **Financial statement fraud** is deliberate misrepresentation, misstatement or omission of **financial statement data** for the purpose of misleading the reader and creating a false impression of an organization's **financial** strength.

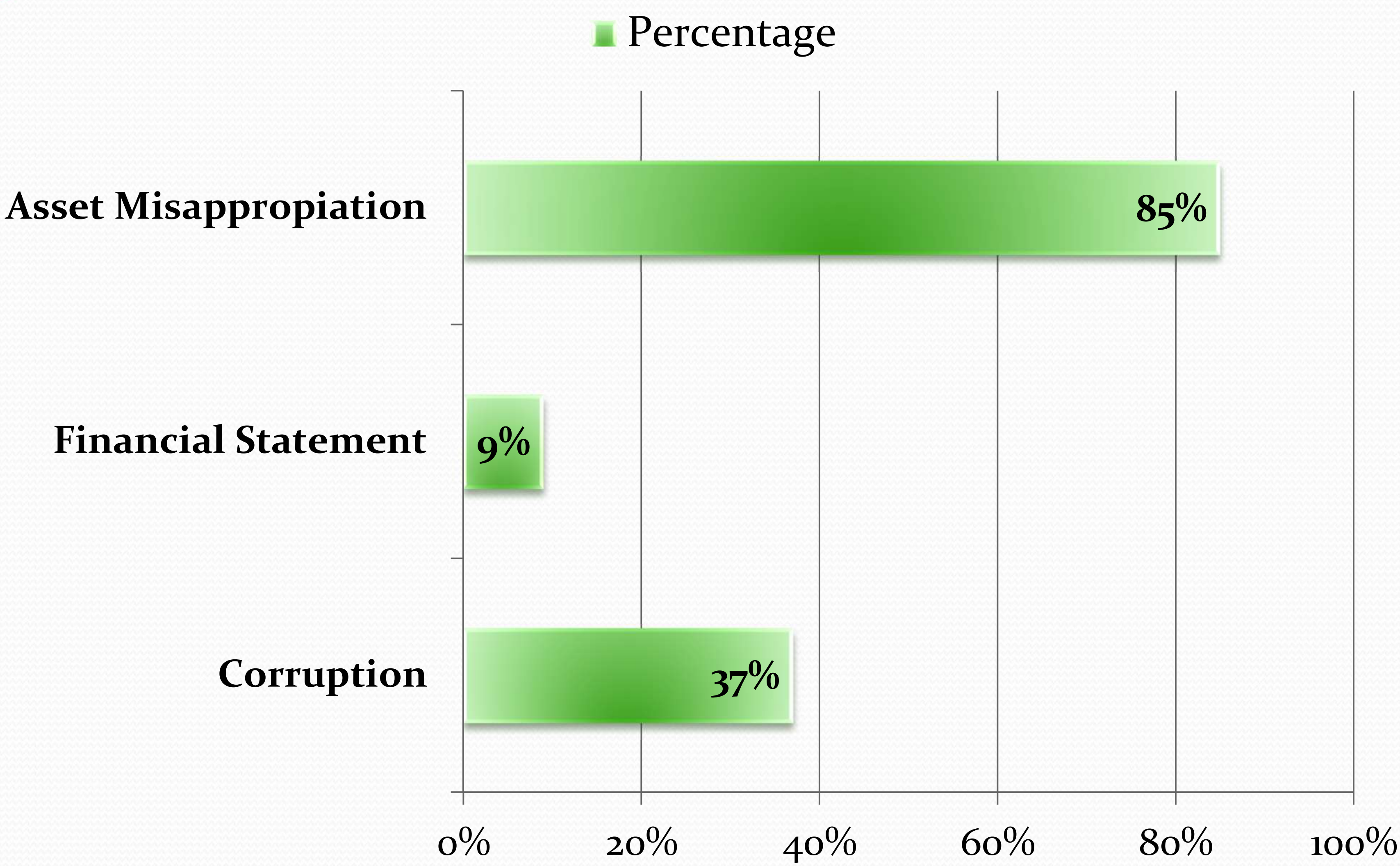
- Elliott and Willingham (1980, 4) view financial statement fraud as management fraud:

  "The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements."

COST OF FSF

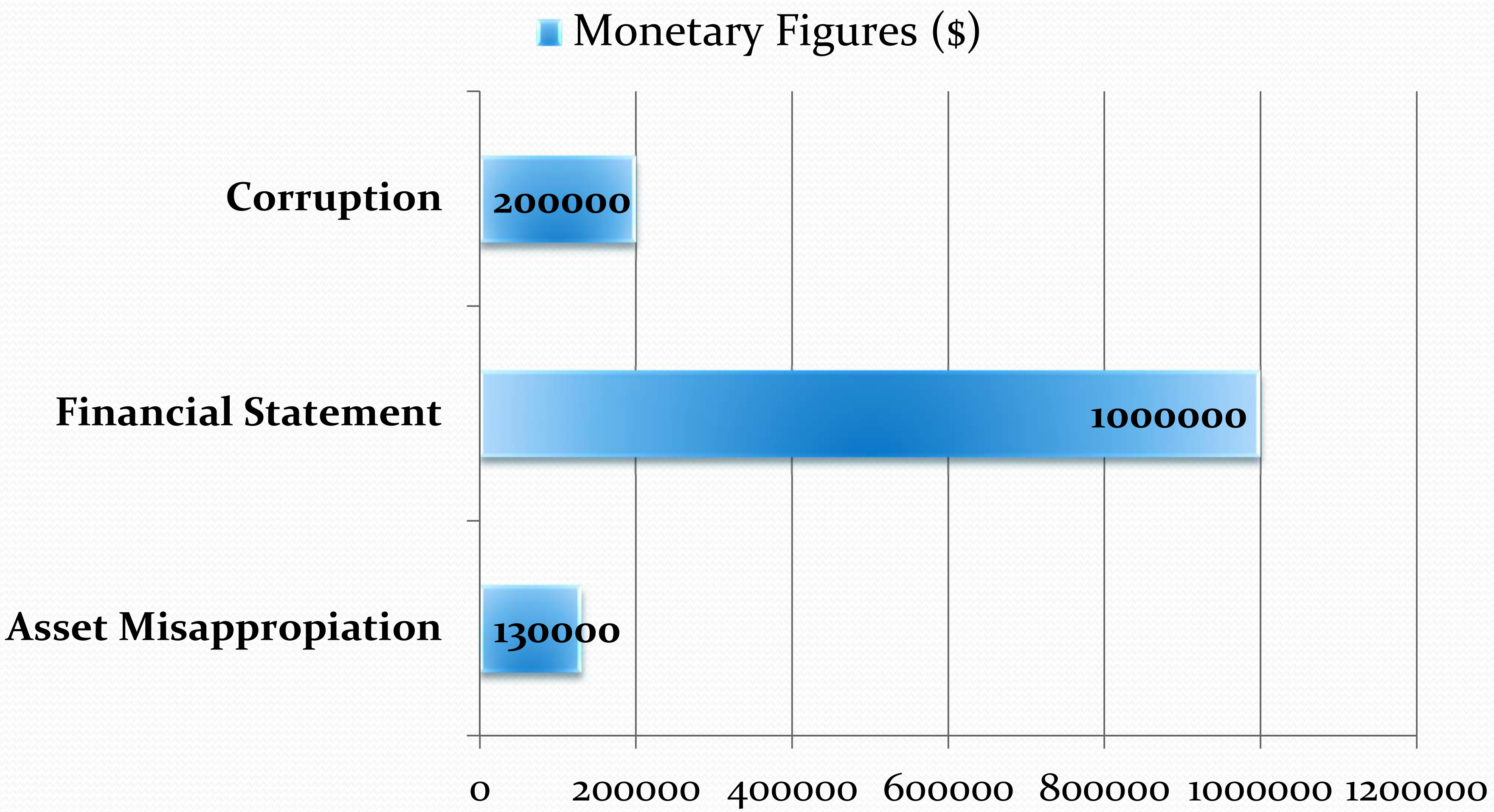
- Enron lost about $70 billion in market capitalization to investors, employees and pensioners.
- Enron, WorldCom, Quest, Global Crossing, and Tyco's loss to shareholders was $460 billion (Cotton 2002).
- Satyam scam eroded $1.5 billion.
- Median loss of $1 million (ACFE 2014 Report).

Occupational Frauds



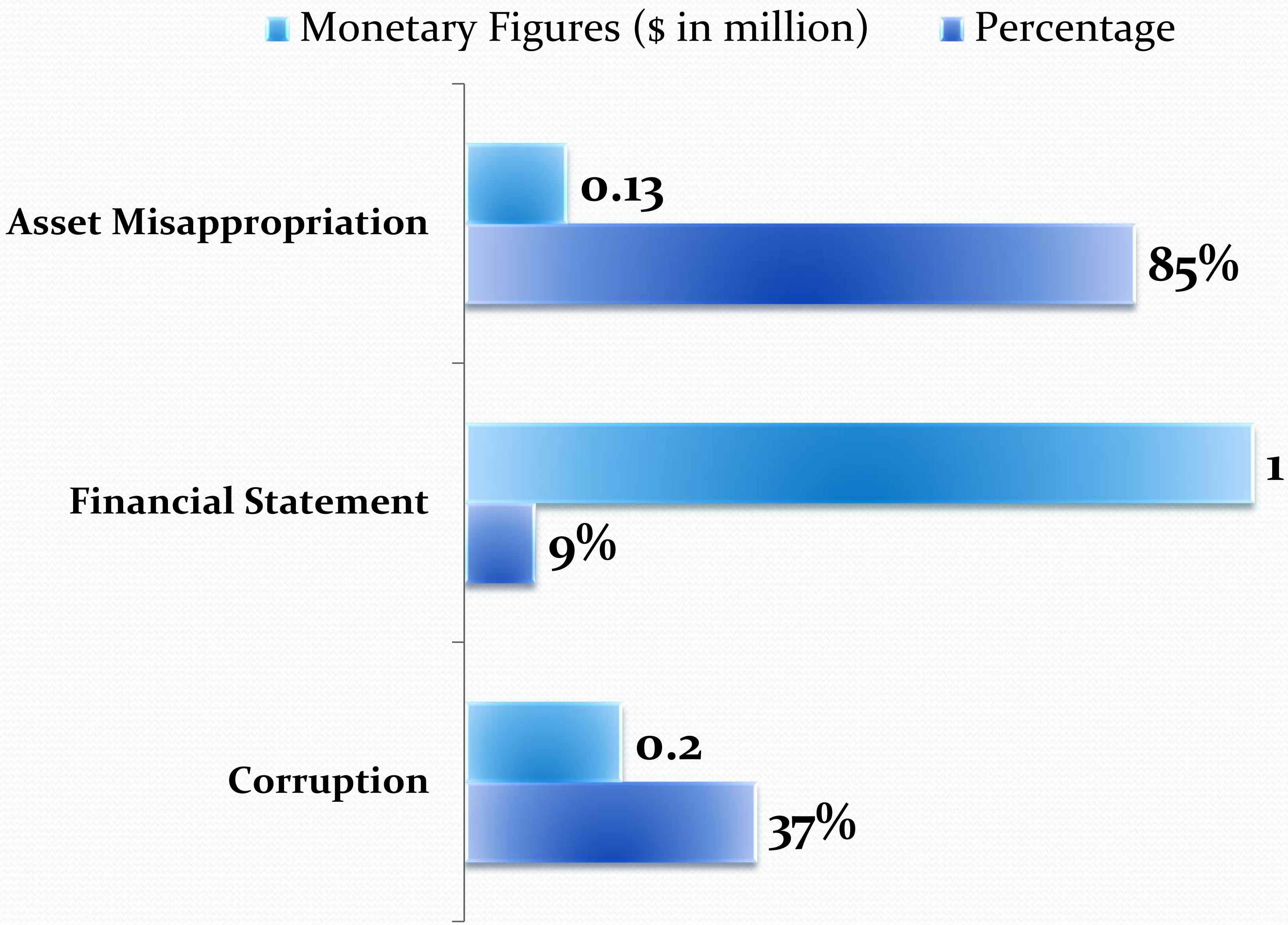
ACFE's REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE 2014

Occupational Frauds



ACFE's REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE 2014

Occupational Fraud



CONSEQUENCES OF FSF

According to Wells (2005 325-327) FSF is harmful in many ways as follows :

- Undermines the reliability, quality, transparency and integrity of the financial reporting process.
- Jeopardizes the integrity and objectivity of the auditing profession, especially auditors and auditing firms.
- Diminishes the confidence of the capital markets, as well as market participants, in the reliability of financial information.
- Huge Loss to Investors.

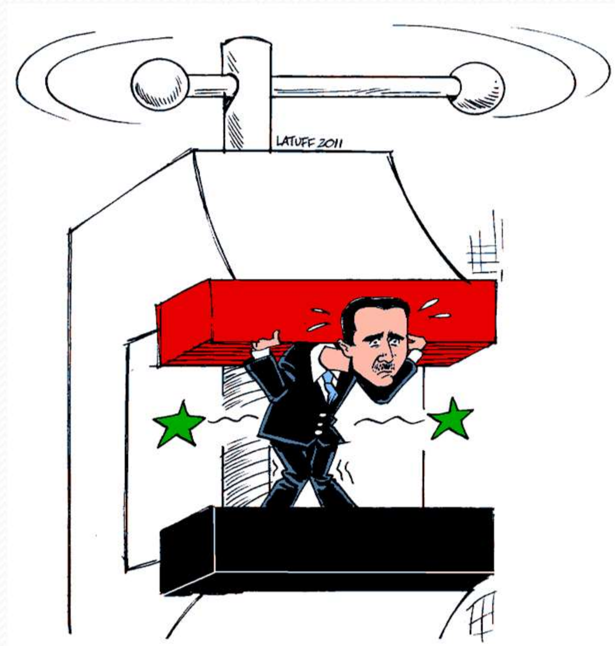
CONSEQUENCES OF FSF

- Adversely affects the nation's economic growth and prosperity.
- Destroys careers of individuals involved in financial statement fraud.
- Causes bankruptcy or substantial economic losses by the company engaged in financial statement fraud.
- Encourages regulatory intervention.

WHAT LEADS TO FSF

PRESSURE

- Force which makes some one to do some act.
- Pressure is what causes a person to commit fraud.
- Desperate people do desperate things.
- Pressure comes in many forms :
  Financial or Non financial.
- Example:
  Repayment of Debt,
  Falling Stock prices,
  to maintain reputation, Etc.



OPPORTUNITY

- Ability to Execute plan with the belief that it will not be unveiled.
- Option(not Obligation) to do something.
- It is created out of weak internal control system.
- Example :

  Chance to grab 2 extra apple when apple seller goes to bring change

RATIONAL

- This is a cognitive stage and requires the fraudster to be able to justify the crime in a way that is acceptable to his or her internal moral compass.

- Example:-
  - The person believes committing fraud is justified to save a family member or loved one.
  - The person believes they will lose everything.
  - The person labels the theft as “borrowing”, and fully intends to pay the stolen money back at some point in future.

GOAL OF FSF

1. To make the performance look better than reality – WINDOW DRESSING
(to entice investment or to 'make the figures');

2. To make the performance look worse – SECRET RESERVE
(to lower the company's tax liability).

HOW FSF CAN BE ACHIEVED

WINDOW DRESSING

- Selling More
- Costing Less
- Owning More
- Owing Less
- Inappropriate Disclosure
- Other Miscellaneous Techniques

HOW FSF ARE COMMITTED

- Playing the accounting system
  (Recording Excess Depreciation/Bad Debts)

- Beating the accounting system
  (Entering fake cash sales)

- Going outside the accounting system
  (Just using PDF/Excel to generate fake statements)

NOTE: Commonly starts with the first method and progressively incorporates the other two methods

WHO COMMMITS FSF

- Senior management (83% of FSF)
- Mid- and lower-level employees
- Organized criminals

Why Senior Management Cooks the Books (Overstatement)

- To meet or exceed the earnings or revenue growth expectations of stock market analysts.
- To comply with loan covenants.
- To increase the amount of financing available from asset-based loans.
- To meet a lender's criteria for granting/extending loan facilities.
- To meet corporate performance criteria set by the parent company.
- To create bogus goodwill in order to fetch higher value on future sell of the company.

Why Senior Management Cooks the Books (Understatement)

- To defer “surplus” earnings to the next accounting period.
- To take all possible write-offs in one “big bath” now so future earnings will be consistently higher.
- To reduce expectations now so future growth will be better perceived and rewarded.
- To preserve a trend of consistent growth, avoiding volatile results.
- To reduce the value of an owner-managed business for purposes of a divorce settlement.
- To reduce the value of a corporate unit whose management is planning a buyout.

CASE STUDY – WHAT TO DO??

Consistent Growth Private Limited is a company founded in Jalgaon in 1997 and is engaged in assembling electronic gadgets. The company has a decade long history of growing its net profit margin by 10% or higher. By the third quarter of 2007, the company was able to attain a sales growth of only 6%. The analysts still believed that the company will get to its target of 10%. The CEO of the company owned 0.5 million shares in the company. Just a week after the end of the financial year 2007, the CFO compiled draft income statement and they had managed to earn 8% growth only. The CEO and CFO concluded that this will result in a 15% drop in market capitalization. The CFO was entitled to receive a bonus of 10% if they achieve the growth target.

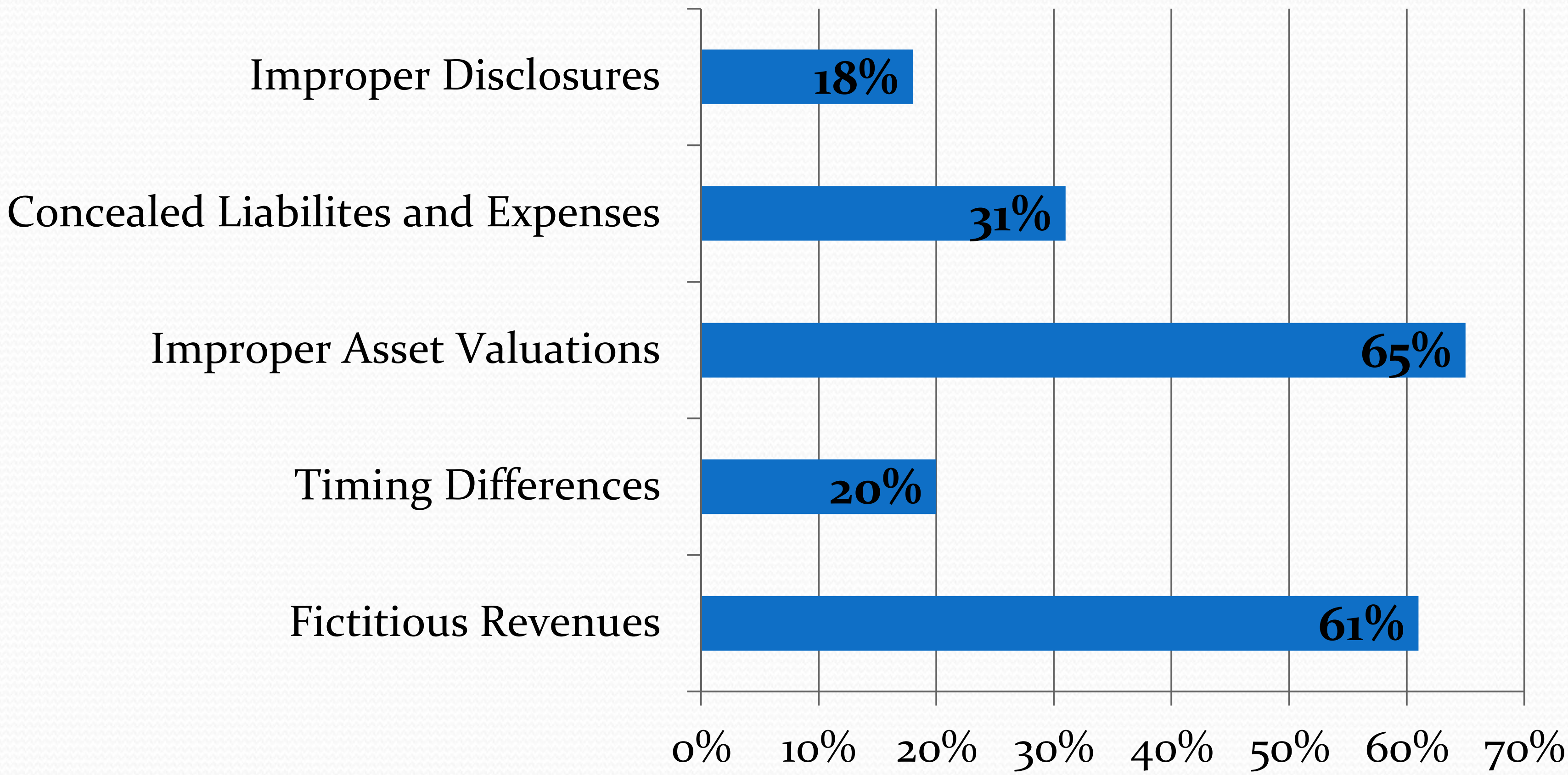
ANSWER

- CEO was able to convince CFO to knock off unearned revenue of $200 million and treat it as earned. This resulted in a net profit margin growth of 11%. The management was able to get the financial statements approved by the board because the directors were not well-versed in accounting principles.

Methods of Financial Statement Fraud

- Fictitious revenues (Selling more)
- Timing differences (Costing less)
- Improper asset valuations (Owning more)
- Concealed liabilities and expenses (Owing less)
- Improper disclosures

Financial Statement Schemes by Category



COSO report, *Fraudulent Financial Reporting 1998–2007*

FICTITIOUS REVENUES

- As per AS 9 revenue shall be recognized when:

  - Activity generating revenue has taken place (Sales/Service).

  - Reasonable assurance that money will be received.
- Fake cash sales.
- Sale to fake or phantom customers.
- Artificial/Inflated sales to legitimate customers.
- Recording sales with conditions.

TIMING DIFFERENCES

- Recording revenue and/or expenses in improper periods.
- Shifts revenues or expenses between one period and the next, increasing or decreasing earnings as desired.
- Excess/Short Depreciation.
- Capitalizing revenue Expenditure.
- Treating Capital Expenditure as Revenue.

IMPROPER ASSET VALUATIONS

- Self Valuation to Inflate the value of asset creating fake reserves.
- Purchasing asset at higher value showing payment in cash.
- Acquiring company at excessive value creating fake goodwill.
- Fake Patent/Copy right.

CONCEALED LIABILITIES AND EXPENSES

- Significant impact on reported earnings & net worth.
- Easier to commit than falsifying sales transactions.
- 3 common methods for concealing liabilities and expenses:
  a) Omitting Liability/expense omissions.
  b) Capitalized expenses.
  c) Failure to disclose warranty costs and liabilities.

TWO VERSIONS OF SATYAM'S ACCOUNTS

(I) SOURCES OF FUNDS	BEFORE CONFESSION	AFTER CONFESSION
(1) **Shareholders Funds**		
a) Share capital	134.70	134.70
b) Share application money, pending allotment	2.76	2.76
c) Reserves and surplus	8392.23	(415.47)
	8529.69	(278.01)
(2) **Loan Funds**		
a) Secured loans	30.49	30.49
b) Unsecured loans- others	234.80	1464.80
	8794.98	1217.28
(I) **APPLICATION OF FUNDS**		
(1) **Fixed Assets**	1381.10	1381.10
(2) **Investment**	618.64	618.64
(3) **Deferred Tax Assets (net)**	118.75	118.75
(4) **Current Assets, Loans and Advances**		
a) Sundry debtors	2651.36	490.00
b) Cash and bank balances	5312.62	272.62
c) Interest accrued on fixed deposits	376.34	0
d) Loans and advances	502.22	502.22
	8842.54	1264.84
Less: current liabilities and provisions		
a) Liabilities	1669.26	1669.26
b) Provisions	496.79	496.79
	2166.05	2166.05
Net Current Assets	6676.49	(901.21)
	8794.98	1217.28

Understated Liability Rs. 1230 crore

Debtors overstated by Rs. 2161 crore

Gap of Rs. 5040 crore in cash

Accrued Interest does not exist

GOWEX' FSF

- Over 90% of Gowex's reported revenues do not exist. Actual revenues was € 8 million as against reported € 182 million.
- GOW's Hotspot network it owns or manages is ~5K in size. CEO told us 100K+ & JB Capital Markets estimates 35K.
- Gowex's largest customer was really itself.
- Gowex told some investors that New York City was paying them €7.5 million. GOW told us €2 million. The real number is <€200,000, according to New York City.

-Report by GOTHAM CITY RESEARCH LLC

Undisclosed related party.

Gotham Estimate of GOW 2013 Revenue		
	Actual	**Reported**
Telecom	€ 2.4	€ 25.4
Wireless	5.75	€ 157.2
Total Revenue	**€ 8.2**	**€ 182.6**

Related Party Customers	2007	2008
Sea Sun Tel S.L.	54.7%	47.4%
Panel Consulting, S.L.	16.5%	18.5%
Line Informatica, S.L.	14.1%	12.7%
Fundacion Red Sin Fronteras	1.5%	0.0%
Total %	**86.7%**	**78.6%**

Thank You

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