ACFE
Association of Certified Fraud Examiners
Together, Reducing Fraud Worldwide

Financial Statement Fraud

Improper Treatment of Sales

Introduction

- Improperly classifying sales transactions can take a wide variety of forms, from fictitious sales to booking loan proceeds as revenues.

Fictitious Revenues

- Fictitious or fabricated revenues involve recording the sale of goods or the performance of services that did not occur.
- Fictitious sales most often involve fake or phantom customers, but can also involve legitimate customers.

Example #1

According to a 1996 SEC complaint for the fiscal year ending June 1994, the president and vice president of California Micro Devices Corporation, a manufacturer of computer chips, conspired to artificially inflate earnings.

Example #1

Under the pressures of ever-increasing revenue goals, Micro Devices began to recognize revenue prior to the product being shipped, paying "handling fees" to distributors to accept product with unlimited rights of return and recording bogus sales to fake companies for products that Micro Devices did not manufacture. Evidence further revealed that one-third of Micro Devices' 1994 revenue was fraudulent.

Fictitious Revenues

- In some cases, companies go to great lengths to conceal fictitious sales.

Sales with Conditions

- Sales with conditions are sales with terms that have not been completed and sales in which the rights and risks of ownership have not passed to the purchaser.
- These sales do not qualify for revenue recognition.

Sales with Conditions

- Obligation to Pay
- Sales to Affiliates
- Sales Conditioned on Approval
- Consignment Sales

Red Flags of Improper Sales

- Rapid growth or unusual profitability compared to that of other companies in the same industry
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth

Red Flags of Improper Sales

- Significant transactions with related parties or special purpose entities not in the ordinary course of business, or where those entities are unaudited or are audited by another firm
- Unusual growth in the number of days' sales in receivables
- A significant volume of sales to entities whose substance and ownership is unknown

Red Flags of Improper Sales

- An unusual surge in sales by a minority of units within a company, or of sales recorded by corporate headquarters
- Significant, unusual, or highly complex transactions, especially those close to period-end that pose difficult "substance over form" questions

Red Flags of Improper Sales

- Unusual increase in gross margin or margin in excess of industry peers
- Unusual decline in the number of days' purchases in accounts payable

CASE STUDY—Manufactured Housing Dealer

- **Locally owned**
- **Big 6 auditor**
- **Purchased by large conglomerate after Big 6 firm due diligence**
- **Intent to take public within 36 months**
- **Bankrupt within 8 months**
- **Revenue recognition was main issue**

<u>*Stated*</u> *Company Policy for Revenue Recognition*

Alternative One

- **Valid down payment received (not just a deposit) and**
  - **Signed sales contract executed and**
  - **Written loan approval obtained**

Alternative Two

- **Full payment and title passes**

Actual Client Policy for Revenue Recognition

If, <u>in your heart,</u> you know it's a sale!

Actual Deposition Quote:

"If you know in your heart it's a firm sale, send it on in."

Per Sales Manager

Revenue Recognition for Purposes of Our Testing

- **Make a reasonable and conservative assumption as to when a sale would be deemed to be completed**
- **TEST? Actual receipt of all sales proceeds <u>within 60 days</u> after the recorded date of the sale.**

The Results—Restated Sales ($ millions)