

# PART ONE

## Revenue-Based Schemes

SIXTY-ONE PERCENT of the financial statement frauds studied in connection with the 2010 report, *Fraudulent Financial Reporting 1998–2007, An Analysis of U.S. Public Companies*, from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) involved misstatements of revenue, making this the single most common category of financial statement fraud. This statistic has been rather consistent over time. In an analysis of SEC AAERs issued from 1982 to 2005, it was reported by Dechow, Ge, Larson, and Sloan that 54 percent of 676 misstatements involved incorrect reporting of revenue.

Since accounting inherently involves two sides to every transaction, when a revenue account is misstated, some other account is likely to be misstated as well. The schemes covered in this part of the book, however, are driven by a desire by the perpetrators to misstate revenue. The other accounts that are affected may be assets, liabilities, expenses, or even other revenue accounts. But, the motive behind the schemes described in this part is to misstate one or more revenue accounts.

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# 1

## CHAPTER ONE

# Introduction to Revenue-Based Financial Reporting Fraud Schemes

## REVENUE RECOGNITION PRINCIPLES

U.S. GAAP describes revenues as inflows or other enhancements of an entity's assets or settlements of its liabilities (or a combination of both) from delivering or providing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. Under IFRS, revenue is defined in IAS 18, *Revenue*, as "The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."

The primary accounting standard governing revenue recognition under IFRS is IAS 18, a comprehensive standard covering numerous considerations. In addition, rules have been published dealing with certain specific types of revenue (e.g., IAS 11 on construction contracts, SIC 31 on barter transactions, etc.).

Under U.S. GAAP, there is currently not a comprehensive revenue standard that is analogous to IAS 18. Instead, there is very broad guidance found in ASC 605, supplemented by standards dealing with specific types of revenue (e.g., revenue from software at ASC 985-605-25) or specific industries (e.g., the music industry at ASC 928-605-25).

As of the writing of this book, however, FASB and IASB are involved in a joint project that will result in changed revenue recognition principles under both U.S. GAAP and IFRS. An exposure draft of a new standard, *Revenue from Contracts with Customers*, was published by FASB in January 2012, with a comment period that ended in March 2012. FASB and IASB had previously jointly issued an exposure draft in November 2011.

For obvious reasons, this book is based on accounting rules currently applicable under U.S. GAAP and IFRS, as well as cases that have been brought forward pertaining to alleged violations of those rules. The proposed new accounting principles will be briefly explained in the next section.

Under ASC 605, revenue should be recognized when it is earned and either realized or realizable. Reference is then made to more comprehensive guidance published by the SEC. The SEC's Staff Accounting Bulletin (SAB) Topic 13 identifies the following criteria that should all be met in order to demonstrate that revenue is realized or realizable and has been earned:

- Persuasive evidence of an arrangement exists
- Delivery of the goods has occurred or the services have been rendered
- The price is fixed or determinable
- Collectibility is reasonably assured

Under IAS 18, revenue from the sale of goods should only be recognized if all five of the following criteria have been met:

1. All significant risks and rewards associated with ownership of the goods have been transferred.
2. The seller does not retain any ownership-like managerial involvement or control over the goods that were sold.
3. The amount of revenue can be measured reliably.
4. It is probable that the economic benefits associated with the transaction will flow to the seller.
5. Transaction costs can be measured reliably.

With respect to recognition of revenue from the provision of services, only the third, fourth, and fifth criteria from the preceding list should be applied. However, in addition, the stage of completion of the project at the end of the reporting period must be able to be measured reliably.

## CHANGES PROPOSED BY FASB AND IASB

The goals of FASB and IASB in proposing a new approach to revenue recognition are to:

1. Remove inconsistencies in existing requirements and improve comparability of revenue recognized under U.S. GAAP and IFRS (hopefully, some of the differences explained in this book will go away once the new standard takes effect)
2. Provide a more robust framework for addressing revenue recognition issues, a framework that can be applied to a wide variety of different revenue arrangements
3. Reduce the number of different revenue recognition rules currently in effect, thereby simplifying research and application of accounting principles

Since the new rules are still in exposure draft format as of the writing of this book, a detailed explanation of them seems pointless. However, a few key points from the draft warrant mentioning.

The core principle of the new standard is that revenue should be recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Five steps would be undertaken to apply this principle:

1. Identify the contract(s) with the customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize revenue when a performance obligation is satisfied

These steps borrow, with some modification, some of the existing revenue recognition concepts, such as the multiple-element revenue arrangement rules introduced in Chapter 2. And the existing basic requirements associated with persuasive evidence, delivery, a determinable price, and collectibility are by no means eliminated. Rather, they are updated and clarified in a manner designed to apply to a wide variety of revenue arrangements.

## OVERVIEW OF REVENUE-BASED SCHEMES

Revenue schemes focus on manipulating revenue. This normally means falsely increasing reported revenue, but in some cases the reverse can be true. Revenue schemes are classified into the following categories:

- Timing schemes
- Fictitious or inflated revenue
- Misclassification schemes
- Gross-up schemes

Think of these categories as the when, why, where, and how of revenue recognition.

Timing schemes shift revenue that belongs in one accounting period to another. Over the course of two or more periods, combined, the fraud self-eliminates. However, since each accounting period stands on its own and must conform to relevant accounting principles, timing schemes represent a form of financial statement fraud. Most commonly, revenue is recognized too soon in the financial statements. This is known as premature revenue recognition.

The rationalization behind prematurely recognizing revenue is simple. The company is borrowing future revenues for today, holding out hope that it can make up for this difference in the next period. This is often done when a company begins to lag behind revenue expectations. The mentality of individuals perpetrating timing schemes is that they feel they will always figure out a way to make the next period successful. They feel that they just need to get through the current period and all will be okay.

Fictitious and inflated revenue both involve fabricating additional revenue to improve profits, decrease losses, or simply appear larger. Fictitious revenue refers to amounts that have been recognized that have no basis whatsoever. Either the customer is fake, the transaction is fake, or both. Inflated revenue, however, starts from a legitimate transaction with a real customer. But, the value of the transaction has been inflated in some manner.

Misclassification schemes do not affect the bottom line of the reporting entity. However, these schemes can have a material impact on certain important financial measures by classifying a transaction improperly, resulting in the transaction appearing on the wrong line of the financial statements.

The final category, gross-up schemes, is designed to accomplish one objective—to make the company appear larger. As with misclassification schemes,

the bottom line is not impacted. Rather, revenue and costs or expenses are overstated in equal amounts. This technique is utilized when growth or a specific revenue goal is desired and the company is falling short.

The remaining chapters of Part I will explain how each of these four types of revenue-based schemes are perpetrated.

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