Management Fraud Puts Auditors between a Rock and a Hard Place

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In today's "earnings crazed" environment, there are times when management, in an effort to whitewash a company's (or a division's) poor performance, may attempt to boost sales by the improper premature recognition of sales. Such decisions may be based on pressures to meet budget projections and goals, or management's compensation may be tied to achieving specified sales targets in the form of bonuses or options, or perhaps the expectations of securities analysts for the company's stock were overly optimistic. A downturn in the economy may contribute to a company's deteriorating financial condition, causing well-meaning management to "cook the books" in order to keep the company afloat, thereby saving their jobs and the jobs of their employees. Whatever the reason, early revenue recognition is a distortion intended to mislead the users of the financial statements.

Common inventory schemes to "pump-up" revenues. A simple early revenue recognition scheme may entail shipping excess (or unordered) inventory to customers and recording fictitious sales prior to the closing of the books for the period. Since the shipment occurred during the period, the accounting records will reflect them as sales, thereby increasing total sales for that period. When the customers return the unwanted goods (as they surely will), the returns are recorded in the subsequent period.

A similar, but more complex variation of accelerated revenue recognition found in the retail industry is the "bill and hold" scheme. In this scheme, outdated or slow-moving inventory is shipped from the company warehouse to an off-site, third party warehouse. The shipment is treated as a sale and a corresponding receivable is recorded.

Let's examine each of these schemes in more detail.

Shipment of excess goods schemes. Repeated use of this scheme artificially inflates sales on the income statement and the allowance for sales returns on the balance sheet. In a sense, it "borrows" against long-term profitability for short-term results. The increased allowance for sales returns will remain on the balance sheet as a “drag” on income in future periods.

An example of an excess shipping scheme would be the XYZ client in the retail fragrance industry. They were pre-shipping goods to drugstore chains and perfume outlets well in advance of their traditional peak sales seasons around Valentine’s Day, Mother’s Day, and Christmas. Normal lead time for shipping was two to three weeks, however, XYZ was shipping in August and September for the year-end holiday season, and recording increased sales during the interim quarters. Customer returns were stored on the receiving dock and not recorded until the beginning of the following year.

Detecting shipment of excess goods schemes: In the XYZ example, the auditors noticed the returned goods on the receiving dock during the inventory observation, and were told that they were “over-shipments.” An inappropriate explanation will always cause a good auditor to dig deeper, so the next logical step in this instance was to look at the customer purchase order, which indicated that the client had indeed been over-shipping to the customers. Excess shipments to customers also can be detected by matching customer purchase orders to the related shipping documents, or by analyzing sales returns.

Matching the quantities per the customer purchase orders to the corresponding shipping documents is a fairly straightforward test to determine if quantities were shipped to customers in excess of what the customer had ordered. Any differences should be investigated further by first reviewing the customer correspondence files to see if any additional goods were requested. The next step would be to contact the customer to confirm that the amounts shipped were indeed what had been ordered. A negative response to these procedures is indicative of intentional shipment of excess goods, a sign of potential inventory fraud.

Examining the relationship of total sales returns to total sales is another effective and efficient analytical procedure that can highlight variances from normal operating trends. In this context, “normal” trends can be defined as prior year, or the average of the past three or five years, or another appropriate benchmark. Excessive sales returns should be further analyzed at the specific customer level to identify which customer accounts are being used to accelerate sales. Other “common sense" procedures are reading the actual credit memos and supporting documentation to determine the reasons for the returns, and reviewing credit memos issued subsequent to the end of the period.

These schemes are usually initiated in the sales department, since the shipping quantities are recorded on the sales orders. The key documents in the sales department are the sales orders, sales invoices, and customer purchase orders. Comparison between and among these documents and the shipping documents may reveal inconsistencies warranting further investigation.

In our XYZ example, the scheme was carried on for almost two years. Sales for each of the quarters and the first year end looked better than they had at any time in the company's history. Not surprisingly, the results for period following the discovery of the scheme were considerably less than everyone expected. XYZ restated their earnings for the three most recent quarters and the prior year, and ultimately filed for bankruptcy.

Bill-and-hold schemes. In this type of inventory scheme, the goods remain in the third-party warehouse until after the close of the accounting period, or may be sold (off the books) to a liquidator, sometimes for less than cost. Any proceeds from the sale of the inventory are applied against the (now overdue) receivable, and the balance is written off as uncollectible. Again, a balance sheet contra account (in this case allowance for doubtful accounts) is artificially inflated, resulting in a greater reduction in net income in future periods.

Sometimes bill-and-hold schemes are the product of collusion between a seller and a customer, whereby the seller requests that the customer orders additional goods before year-end, and books the sale in order to achieve a target sales level. The goods remain with the seller, and are not shipped until the subsequent period. In exchange for placing the order, the seller offers the customer the goods at a reduced cost.

An example of a bill-and-hold scheme in recent years occurred at Sunbeam, where management overstated revenues for 1997 by some $95 million, and net profits by $71 million. Granted, in the case of Sunbeam, the bill and hold scheme was but a single component of a repertoire of tricks that included inappropriate accounting reserves, channel stuffing, recording revenues on contingent sales and booking future sales in the current quarter (look for a discussion of these techniques, and how to detect them, in future articles).

Detecting bill-and-hold schemes: Generally, such detection requires you to draw together facts from various parts of the company's operations, including shipping/receiving, accounting, and sales. If inventory was being moved to an off-site warehouse, the loading dock personnel would certainly be involved in the shipping process. Questioning the shipping foreman (as well as any other key shipping/receiving personnel) as to the timing of shipments and the alteration or destruction of shipping documents may open additional lines of investigation.

Since these schemes require the use of additional warehouse space, you should perform an analytical review of the expense accounts for unexplained off-site storage rental expenses. Likewise, a review of the monthly shipping costs will reveal an increase in shipping costs near the end of the accounting period.

As noted in the excess shipment scheme, inquiries and review of documentation in the sales department may reveal sales to fictitious new customers, or sales to pre-existing customers with new delivery instructions. Analysis of sales by customer will highlight increased sales activities, and a telephone confirmation with the customer(s) of changes to delivery instructions may expose the third-party warehouse where the inventory is being stored.

Other procedures to consider include agreeing the customer credit limits and delivery addresses from the customer contract to the sales and shipping documents, and analysis of the timing of customer sales. Most fictitious sales associated with bill and hold schemes are recorded near the end of the accounting period, and since they are in excess of customer sales in the normal course of business, the may exceed the company's credit limits.

A final note. Premature revenue recognition schemes involving the movement of inventory requires the participation of resources throughout the organization (see accompanying sidebar "SEC brings charges for bill and hold scheme"). Records are falsified, necessary authorizations are not obtained, and internal controls are overridden or otherwise ignored. Management complicity in these schemes, often motivated by financial need, may present impediments to your inquiries. Such resistance or obstruction of your efforts is one of the major red flags that an investigation is moving in the right direction. In these instances, your professional skepticism and diligence can mean the difference between successfully identifying a pattern of activity that may enrich a few, but could ultimately cost your company's shareholders, employees and lenders far greater amounts.

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