

Sample listing of fraud schemes



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The following listing of possible fraud schemes can be utilized by management and auditors to assist in identifying possible fraud risks, scenarios, and schemes when performing or evaluating management's fraud risk assessments. The listing of fraud schemes is not intended to be a complete listing of all possible fraud schemes for all industries.

Fraudulent Financial Reporting Schemes

Improper Revenue Recognition

Side Agreements - Sales terms and conditions may be modified, revoked, or otherwise amended outside of the recognized sales process or reporting channels and may impact revenue recognition. Common modifications may include granting of rights of return, extended payment terms, refund, or exchange. Sellers may provide these terms and conditions in concealed side letters, e-mails, or in verbal agreements in order to recognize revenue before the sale is complete. In the ordinary course of business, sales agreements can and often are legitimately amended, and there is nothing wrong with giving purchasers a right of return or exchange, as long as revenue is recognized in the proper accounting period with appropriate reserves established.

"Roundtrip" Transactions - Recording transactions that occur between two or more companies for which there is no business purpose or economic benefit to the companies involved. These transactions are often entered into for the purpose of inflating revenues or creating the appearance of strong sales growth. Transactions may include sales between companies for the same amount within a short time period, or they may involve a loan to or investment in a customer so that the customer has the ability to purchase the goods. Cash may change hands, but payment alone does not legitimize the transaction or justify the recognition of revenue if there is no underlying business purpose or economic benefit for the transactions.

Bill and Holds - A bill and hold transaction takes place when products have been booked as a sale but delivery and transfer of ownership has not occurred as of the date the sale is recorded. The transaction may involve a legitimate sales or purchase order; however, the customer is not ready, willing, or able to accept delivery

of the product at the time the sale is recorded. Sellers may hold the goods in its facilities or may ship them to different locations, including third-party warehouses.

Altering Shipping Documentation - By creating phony shipping documentation, a company may falsely record sales transactions and improperly recognize revenue. By altering shipping documentation (commonly changing shipment dates and/or terms), a company can increase revenue in a specific accounting period regardless of the facts and circumstances that the transaction and the resulting revenue should have been recorded in the subsequent accounting period.

Agreements to "Sell-Through" Product - These sales agreements include contingent terms that are based on the future performance of the buyer of the goods (commonly distributors or resellers) and impact revenue recognition for the seller. These contingent terms may or





may not be included in the sales agreements and may be provided in side agreements. "Sell through" agreements are similar to consignment sales and can involve shipment of goods to a party who agrees to sell them to third parties. A sale is not considered to have taken place (and therefore revenue should not be recorded) until the goods are sold to a third party (a customer or end-user) with no additional contingent sales terms.

Up-Front Fees - Some sales transactions require customers to pay up-front fees for services that will be provided over an extended period of time. Companies may attempt to recognize the full amount of the contract or the amount of the fees received before the services are performed (and before revenue is earned). In some instances, the scheme may involve the falsification or modification of accounting records (e.g., purchase orders, invoices and sales contracts).

Holding Accounting Periods Open - Improperly holding accounting records open beyond the end of an accounting period can enable companies to record additional transactions that occur after the end of a reporting period in the current accounting period. This scheme commonly involves recording sales and/or cash receipts that occur after the end of the reporting period in the current period. Schemes sometimes include falsification or modification of accounting documentation (dates on shipping documents, purchase orders, bank statements, cash reconciliations, cash receipt journals, etc.) in an attempt to cover the trail of the fraud.

Failure to Record Sales Provisions or Allowances - Some sales transactions require companies to record provisions or reductions to gross sales amounts (e.g., to account for future sales returns). By failing to record sales provisions or reductions, companies can improperly overstate revenues. The scheme may involve the

falsification or modification of accounting records in an attempt to hide the terms or conditions that may require the sales reduction (e.g., purchase orders, invoices and sales contracts).

Inventory Schemes

Inflating the Value of Inventory - Inventory valuations can be manipulated in a number of ways, including: moving inventory between locations to fictitiously inflate inventory quantities, postponing and under-reporting of write-downs and reserves for obsolescence, manipulating unit valuations applied to on hand inventories, and improper inventory capitalization.

Off-Site" or Fictitious Inventory - Companies may "create" inventory by falsifying journal entries, receiving and shipping reports, purchases orders, or cycle counts. Companies may participate in these schemes to decrease cost of sales as a percentage of sales or maintain inventory balances for debt covenants or other reasons.

Other Financial Reporting Schemes

Fraudulent Audit Confirmations - Fraudulent audit confirmations can impact all types of accounts or transactions that are confirmed with third parties (sales, cash, accounts receivables, debt, liabilities, etc.). Schemes may involve collusion with third parties who receive the audit confirmations or may involve the company providing the auditors with false contact information (false mailing addresses, fax numbers, phone numbers, etc.) so that confirmations are diverted to co-conspirators involved in the scheme.

"Refreshed" Receivables - In order to mask rising account receivable balances (including known or suspected uncollectible balances) while avoiding increasing the bad debt provision, a company may "refresh" the aging of receivables and improperly represent A/R balances as being current in nature instead of showing the true age of the receivables. This may occur with exchange transactions with customers, where customers can receive "credits" to their accounts and allowed to repurchase goods where little, if any,

physical transfer of merchandise occurs. Some schemes may simply modify or edit dates of invoices in the A/R system that results in a "restart" of the aging process for the modified receivables. Schemes may involve the falsification or improper modification of accounting documentation (invoices, purchase orders, change orders, shipping reports, etc.) to cover up the fraud scheme.

Promotional Allowance Manipulations - Promotional allowances may be provided as rebates, incentives, or other credits to buyers/customers as an incentive to purchase products. Allowances may take the form of volume discounts, reimbursements for special handling, co-advertising reimbursements, slotting fees, etc. Often promotional allowances are based on future events (such as purchase volumes over a specified period of time, future advertising costs, etc.) and often require considerable estimates that may be manipulated or biased. Some schemes involve the early recognition of revenue on up-front fees collected or the failure to accrue for rebates or credits that are likely to be earned by the buyer. Other fraud schemes involve fraudulent financial reporting and the misclassification of credits on the income statement.

Adjustments to Estimates - Estimates are common throughout the accounting process and can be manipulated to impact revenues, expenses, asset valuations, and/or liabilities. Management is often in a position where it can influence or bias estimates. Common fraud schemes involve the reduction of accruals or reserves in order to increase earnings in the current period, and may involve the earlier creation of excess reserves or "cookie-jar reserves" when the company was in a financial position to create a "cushion" against future losses.

Off-Balance-Sheet Entities and Liabilities - Some schemes involve the use of "off-balance-sheet" vehicles or special purposes entities to conceal liabilities. Off-balance-sheet vehicles may be allowable under Indian GAAP; however, some schemes are designed to utilize these entities or transactions to conceal debt and misstate liabilities on the balance sheet and may also have income statement impact as well.

Improper Asset Valuations - There is often a direct relationship between the overstatement of assets and inflation of earnings. Many fraud schemes involve the "hiding" or misplacement of debits on the balance sheet that should be recorded on the income statement. These debits are often improperly recorded as assets or a reduction to existing liabilities. Overvaluing assets is often considered a relatively "simple" way to directly manipulate reported earnings.

Phony "Investment Deals" - Designed to overstate assets and earnings, schemes can deliberately overstate existing investments or create fictitious investments. Investments may also be intentionally misclassified resulting in the improper recognition of gains or failure to recognize losses. Other schemes are designed to hide or defer losses from sales or permanent write downs from impairments.

Improper Capitalization of Expenses - Capital expenditures are costs that benefit the company over more than one accounting period, and accordingly, the expenditures should be amortized over the life of the asset. Companies may improperly capitalize certain expenditures in order to avoid recognizing the full amount of the expense in the current period. Expenses may be capitalized into various asset accounts, and may include software development costs, research and development costs, start-up costs, interest costs, advertising costs, inventory and labor costs, etc.

Adding Back Outstanding Checks to Cash - Cash reconciliations can be manipulated in order to inflate ending cash balances. Some schemes are accomplished with one "reconciling" item or adjustment on the reconciliation, or may involve selecting and removing specific checks from the outstanding check registers.

Unjustified Consolidation Entries - Some schemes occur during the financial closing and consolidation process and involve un-justified or fictitious consolidation entries. Often there is limited accounting documentation or explanations for consolidation entries and activities.

Intercompany Manipulations - Similar to other accounting schemes involving consolidations, intercompany manipulations may have limited documentation or explanations for inter-company entries and activities. Schemes may occur to over/understate balances or may involve the creation of fictitious transactions.

Related Parties That "Create" Transactions - Related-party transactions are made with entities that are controlled or influenced by the company. Schemes may involve improper or inadequate disclosure of transactions or more elaborate schemes to "create" fictitious transactions between entities, often with the intent to increase reported revenues or assets.

Disclosure Frauds - Fraudulent disclosures may include providing false information or the failure to disclose required information. Schemes may involve a company's failure to disclose certain transactions with related parties, material asset impairments, unrecorded liabilities or accounting practices that violate Indian GAAP.

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Misappropriation of assets

Skimming of Cash - Skimming schemes often involve the sales cycle, where employees embezzle by not recording the sale or full amount of the cash collected. A typical skimming scheme might involve a retail store where an employee collects cash from a customer, pockets the money, and avoids recording the

transaction in the point of sales system. Other skimming schemes are not limited to cash transactions and may involve diverting customer checks.

Fraudulent Disbursements - Schemes may include billing schemes, procurement fraud, theft of company checks, payroll and "ghost employee" schemes, and expense reimbursement schemes. A common procurement scheme is to set up phony vendors or suppliers in the accounts payable system or approve payments for services that are received by the employee or co-conspirator. Payroll schemes can include falsification of hours worked creation of fictitious employees, failure to remove employees who have left the company and the diversion of payments to employees or co-conspirators.

Other fraud schemes

Bribery, Corruption, & Kickbacks - Corruption and bribery may take a variety of forms within an organization and may include such items as vendors paying "gratuities" to buyers to secure sales, buyers paying premiums to vendors because of a buyer's personal relationships, payments to "shell companies" for soft services that are not actually rendered, payment terms are "structured" to avoid proper approval signatures, or the same vendor may appear in the payables system in numerous ways as a method of making duplicate payments. Schemes may also involve preferred service providers who are willing to pay kickbacks to individuals for the company's business.

Money Laundering - Money laundering is the process of concealing the source of illegally obtained money. This process is of critical importance to the perpetrator, as it enables the criminal to enjoy profits without revealing their source. Activities may involve disguising the sources, changing the form, or moving the funds to a place where they are less likely to attract attention. Money laundering profits may come from embezzlement, insider trading, bribery, computer fraud schemes, illegal arms sales, smuggling, and the activities of organized crime.

Questions to consider



The following is a list of some of the questions for management to consider when designing and evaluating antifraud programs and controls. Management should consider and evaluate the facts and circumstances for their organizations (e.g., the entity's industry, operations, geographical locations, size, organizational structure, and general economic conditions) and tailor their antifraud programs and controls accordingly. The following questions and themes are adopted from various sources, including the Sarbanes-Oxley Act of 2002, SEC's Final Rules on Sarbanes-Oxley, SAS 99, PCAOB Auditing Standards No. 2, COSO and Clause 49 of the listing agreement.

Fraud Risk Assessment

1. Does the company have formal and regularly scheduled procedures to perform fraud risk assessments?
2. Are appropriate personnel involved in the fraud risk assessments?
3. Are fraud risk assessments performed at all appropriate levels of the organization (such as the entity level, significant locations or business units, significant account balance or major process level)?
4. Does the fraud risk assessment include consideration of internal and external risk factors (including pressures or incentives, rationalizations or attitudes, and opportunities)?
5. Does the fraud risk assessment include the identification and evaluation of past occurrences and allegations of fraud within the entity and industry? Does it include the evaluations of unusual financial trends or relationships identified from analytical procedures or techniques?
6. Does the fraud risk assessment consider the risk of management's override of controls?
7. Does management consider the type, likelihood, significance, and pervasiveness of identified fraud risks?
8. Are fraud risk assessments updated periodically to include considerations of changes in operations, new information systems, acquisitions, changes in job roles and responsibilities, employees in new positions, results from self-assessments of controls, monitoring activities, internal audit findings, new or evolving industry trends, and revisions to identified fraud risks within the organization?
9. Does management assess the design and operating effectiveness of the fraud risk assessments?
10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the fraud risk assessments?
11. Is the fraud risk assessment designed and operating effectively?

Control Environment

1. Does the company maintain a proper tone at the top? Did management assess the tone of the organization to determine if the culture encourages ethical behavior, consultation, and open communication? (This assessment can be made through anonymous cultural surveys, inquiries and interviews, or by internal audit review.)
2. Do the audit committee and the board of directors have sufficient oversight of management's antifraud programs and controls?
3. Does the internal audit function have sufficient involvement in antifraud programs and controls, including monitoring of the effectiveness of antifraud programs and controls, given the size and complexity of the organization? Does the internal audit function report directly to the audit committee?
4. Does the company have a published code of ethics/conduct (with provisions related to conflicts of interest, related-party transactions, illegal acts, and fraud) made available to all personnel and does management require employees to confirm that they

accept and agree to follow it? Does the frequency of exceptions undermine the code's effectiveness? Does the code comply with all applicable rules and regulations?

5. Does the company have an ethics/whistleblower hotline with adequate procedures to handle anonymous complaints (received from inside and outside the company), and to accept confidential submission of concerns about questionable accounting, internal accounting control, or auditing matters? Are tips and whistleblower complaints investigated and resolved in a timely manner?

6. Does the company have formal hiring and promotion standards, including background checks for those employees with influence over financial reporting or involved in the preparation of the financial statements?

7. Does the company have formal and effective training for employees and new hires on issues of fraud, ethics, and the code of ethics/conduct?

8. Does the company respond in a timely and appropriate manner to significant control deficiencies, allegations or concerns of fraud, and violations of the code of ethics/conduct?

9. Does management assess the design and operating effectiveness of the control environment?

10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the control environment?

11. Is the control environment designed and operating effectively?

Antifraud Control Activities

1. Does the company adequately map or link identified fraud risks to control activities designed to mitigate the fraud risks?

2. Does management design and implement preventative and detective controls (preventative controls are designed to stop fraud from occurring and detective controls are designed to identify the fraud if it occurs)?

3. Does the company have controls that restrain the misappropriation of company assets that could result in a material misstatement of the financial statements?

4. Does the company have controls that address the risk of management's override of controls (including controls over journal entries and adjustments, estimates, and unusual or non-routine transactions)?

5. Does the company consider security controls (including IT controls and limited access to accounting systems), and consider the adequacy of fraud detection and monitoring activities utilizing information systems?

6. Does management assess the design and operating effectiveness of antifraud control activities?

7. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of antifraud control activities?

8. Are antifraud control activities designed and operating effectively?



Information & Communication

1. Is information on ethics and management's commitment to antifraud programs and controls effectively communicated throughout the organization to all employees?
2. Does management have procedures to disseminate and collect information regarding antifraud programs and controls, fraud risks, allegations of fraud, and concerns of improper accounting to and from all levels of the organization and external parties (where appropriate)?
3. Does management assess the design and operating effectiveness of information and communication?
4. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of information and communication?
5. Are procedures and activities for communicating information regarding antifraud programs and controls designed and operating effectively?

Monitoring Activities

1. Are internal audit and others actively involved in monitoring and assessing antifraud programs and controls?
2. Is the internal audit activity adequate for the size and operations of the organization?
3. Are findings and weaknesses identified during monitoring activities incorporated back into the fraud risk assessment, the design of the control environment and antifraud control activities?
4. Does the audit committee have oversight of monitoring activities?

5. Does management assess the design and operating effectiveness of monitoring activities?
6. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the monitoring activities?
7. Are monitoring and assessment activities designed and operating effectively?



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