A CFO, bullied by the CEO, used creative accounting and fraudulent schemes to falsely improve a company's bottom line. Here's how he did it and what to keep an eye out for in your organization.

The chief financial officer's accounting fraud was intended to improve the company's financial statements and inflate its stock price. Mission accomplished on both accounts. The fraud led to increased market capitalization for the company and millions of dollars in losses for stockholders who bought the stock at inflated prices.

The CFO succeeded in his scheme for almost two years. An astute member of the financial press ultimately exposed the fraud, which led to criminal charges. The CFO eventually served five years in prison for securities fraud.

This article highlights the mechanics of how he accomplished his fraud using creative schemes to boost revenue, lower cost of goods sold and inflate net income.

In writing this article, I hope to raise awareness of his schemes and help fraud examiners prevent and catch these kinds of accounting gimmicks.

I was involved as an attorney and CFE in civil litigation that overlapped with the criminal case. I analyzed accounting records and audit work papers, assisted in a deposition of the CFO in prison and attempted to piece together the puzzle of the CFO's fraud, among other
things. The identities of the CFO and the company will remain anonymous because certain information in the case was non-public in nature.

**The pressuring CEO**

The chief executive officer of the company heavily pressured the CFO (I’ll call him Jack) to report growing earnings. The CEO gave aggressive financial projections to the media, and then he pushed Jack to meet the market’s expectations. The CEO had a domineering, threatening personality. Jack was relatively new to the company and was hesitant to say no to his strong-willed boss.

Jack owned shares of the company's stock. Although that was an incentive to inflate the stock price, his main motivation was to please the CEO. Jack had no stock options or incentive-based bonuses.

The expectations of Wall Street and the CEO proved tough to meet. Jack needed a crutch to creatively meet the push for strong financial results. Initially, he used a few minor accounting tricks to improve the short-term bottom line; he didn’t intend for them to evolve into a long-term solution or full-fledged fraud. He planned on reversing most of the fraudulent transactions in later accounting periods. Jack hoped that future sales growth — triggered by a new product in the pipeline — would significantly and discreetly absorb the effects of reversing the fraudulent transactions. However, the sales growth never materialized, and Jack wasn’t able to cover his tracks.

The pattern should sound familiar to fraud examiners. It’s a classic example of the motives and snowball effect that often lead to large-scale fraud.

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**Fictitious sales invoices**

A key component of Jack’s fraud was fictitious sales transactions. His starting point in booking these transactions was to create false invoices in the company’s accounting system. There were no underlying customer orders, shipping documents or payments. Jack simply entered information into the invoice system such as a real or fake customer name, item description, unit price, quantity and sale date. When the system created the invoices, the system automatically recorded a debit to the accounts receivable (AR) general ledger account and credit to the sales account. Creating the invoice was easy. The tougher part was dealing with the fraudulent AR that remained on the company’s books from these transactions.

Jack subsequently cleared some of the AR off the books with cash received from unrelated transactions to make it appear that the fraudulent account receivable was paid off. For example, in one instance the company received cash from a large investor for the payoff of a receivable from the investor’s prior purchase of stock. When the incoming cash was received, Jack correctly booked it as a debit to cash. However, he booked the credit portion of the entry to AR from the fictitious sale rather than the receivable from the investor. Thus, the fraudulent AR balance was no longer on the company’s books at year-end.

In other instances, he left the AR from fictitious sales on the company’s books through year-end. This was risky because Jack knew the auditors would review and test at least some of the company’s year-end AR balances. In fact, for one of the fake receivables, the auditors sent an audit confirmation to the listed customer. The customer was a real entity that conducted prior business with the company, but it was run by an accomplice, who aided in the company’s fraud. The accomplice signed the confirmation, falsely agreeing that the sale took place and that the receivable was legitimate.

Jack, a former auditor, knew most of the audit procedures that the company’s auditors would perform at year-end. More importantly, he knew ways to evade them. For example, he often recorded the fictitious sales in small amounts to avoid creating an unusually large transaction or significant accounts AR balance that might attract the auditor’s attention. He was also careful to record the sales at least five days before year-end to avoid any cutoff tests.

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Sales with no corresponding cost of goods sold

Some of the fictitious sales were booked with corresponding cost of goods sold (COGS) entries; however, some weren't. COGS is an expense account that reflects the cost basis of sold inventory. The absence of COGS entries meant that the sales were booked with a 100 percent profit margin. In other words, the entire amount of the sale directly increased net income because no corresponding COGS entry was booked to an expense account to record the cost basis of the sold inventory.

To illustrate, sales entries in legitimate accounting systems are generally booked as a debit to AR and credit to sales for the total amount of the sale. A corresponding entry is booked as a debit to COGS and credit to inventory for the company's cost basis of the inventory. The latter entry removes the sold inventory from the company's books. The cost basis of the inventory is usually less than the sales price, with the difference representing the company's profit from the sale.

In cases where no COGS entry was booked (i.e., no debit to COGS, and no credit to inventory), no expense was recorded to net down the company's revenue from the sale. So, the entire sale amount represented profit flowing through to net income.

The company's accounting system automatically booked a debit to COGS and credit to inventory when an inventory item number was listed on the sales invoice. In instances where the CFO wanted to avoid the COGS entry, he simply excluded an inventory item number on the invoice. Alternatively, if an inventory item number was listed on the invoice, he sometimes recorded a manual journal entry to reverse the COGS entry booked by the system. The end result was a sale transaction booked with a 100 percent profit margin.

Exaggerated profit margin for otherwise legitimate sale

On at least one occasion, Jack manipulated an otherwise legitimate sale transaction, after the sale was booked, to exaggerate the profit margin. He did this by entering the accounting system and lowering the quantity of goods for the inventory component of the transaction. When he lowered the quantity, the accounting system automatically adjusted the COGS entry to decrease the amount of the entry based on the lower quantity of goods. This caused an increase in profit margin from the sale, which flowed through to net income.

Otherwise legitimate revenue pulled into earlier accounting periods

Jack also pulled otherwise legitimate sales transactions into earlier accounting periods to prematurely recognize revenue from the sales.

He did this, after the sale took place, by changing the date on the sales invoice in the invoice system to reflect an earlier date. The original accounting entries on the general ledger (debit to AR, credit to sales; debit to COGS, credit to inventory) were then automatically backdated to the earlier date.

Jack usually pulled off this scheme between quarters instead of fiscal years, which minimized the possibility of detection because he knew the auditors conducted more thorough reviews annually than quarterly.

In conjunction with pulling revenue forward, Jack sometimes backdated otherwise legitimate shipping documents to change the shipping dates to the earlier periods. Jack essentially replaced the actual date on a shipping document with a false date, which coincided with the date of the manipulated sales invoice. The underlying shipments to customers were real — he simply manipulated the dates to make it appear that they took place in an earlier period. He used this tactic to create a more robust paper trail for the fraudulent transactions.

Pushed cost of goods sold into later accounting periods

Jack also pushed COGS entries (debit to COGS, credit to inventory) for otherwise legitimate sales into later accounting periods. This resulted in a 100 percent profit margin on the sale in the earlier period because the COGS expense was
transferred to the later period but the sale entry (debit to AR, credit to sales) remained in the earlier period.

Jack usually committed this scheme between quarters, instead of fiscal years, which minimized the chances of the auditors detecting it at year-end.

This scheme left the inventory balance on the company’s balance sheet temporarily overstated. To illustrate, inventory was physically shipped to the customer in the earlier quarter when the sale took place. But because the inventory entry (debit to COGS, credit to inventory) was pushed back to a later quarter, the inventory balance on the balance sheet temporarily varied from the company’s physical inventory on hand. The variance was corrected in the subsequent quarter when the inventory entry (debit to COGS, credit to inventory) was booked. Because Jack resolved the variance before year-end, the auditors’ year-end physical inventory observation wouldn’t have detected the fraud.

**Double-booked sales transactions**

Jack also double-booked certain sales transactions. In these cases the original transaction was a legitimate sale to an actual customer. However, at some point after the original transaction was booked in the accounting system, Jack then created a duplicate sales invoice in the system. The invoice triggered a second set of accounting entries to duplicate the sale.

Jack could use the same shipping records and other source documents from the legitimate sale to substantiate the fictitious sale if the auditors requested backup for the fictitious sale.

**The fraud unravels**

The fraud began to unravel when a member of the financial press questioned the legitimacy of the company’s growing revenues. Soon after the article was published, government regulators, including the Securities and Exchange Commission (SEC), began to investigate. Federal prosecutors then got involved and eventually filed criminal charges. Also, defrauded investors filed a class action.

A colorful picture emerged of Jack’s creative schemes to inflate revenue, decrease cost of goods sold and overstate net income. Jack ultimately pled guilty to the criminal charges, and a settlement was reached in the class action.

In this case, the company believed it could do little to prevent the fraud because it was orchestrated at the highest level of management. Additional segregation of duties would have helped, but even then, the CFO had ultimate authority over the transactions. However, there are several ways a company can prevent financial statement fraud at the highest levels. (See the sidebar, “How to prevent financial statement fraud at the management level” on page 22.)

And, of course, the U.S. Sarbanes-Oxley Act requires that CEOs and CFOs of public companies personally certify annual and quarterly SEC filings. These certifications essentially require CEOs and CFOs to be responsible for their companies’ financial statements and prevent them from delegating this responsibility to their subordinates and then claim ignorance when fraud is uncovered in the financial statements.

Hopefully, you’ll be able to use the nuts and bolts of Jack’s fraud as a learning tool to identify these types of schemes long before they become media headlines. = FM

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**COSO report: CEO and CFO are top offenders in U.S. fraudulent financing reporting cases**


Among other highlights, the report stated:

- The CEO was named as one of the top parties involved in 72 percent of the fraudulent companies. The second most frequently identified senior executive was the CFO, who