PacificCPE

COURSE
10201A

Foundations of Fraudulent Financial Reporting

Get oriented to the world of fraudulent financial reporting with this introductory module. Designed for CPAs and financial professionals, this course lays the groundwork for understanding how financial statement fraud occurs, why it matters, and what you'll explore throughout the broader curriculum. You'll review course objectives, learning assignments, and the exam structure so you can approach the material with a clear roadmap. A solid starting point for anyone looking to strengthen their fraud awareness and detection skills.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize management fraud techniques as they relate to misstated financial statements.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: May 2026

TABLE OF CONTENTS

CHAPTER 01

Management Fraud 4

1.01 Improper Revenue Recognition 6

1.02 Revenue Recognition In Wrong Period 7

1.03 Improper Sales Accounting 10

1.04 Inadequate Disclosure Of Related-Party Transactions 16

1.05 Improper Asset Valuation 20

1.06 Inadequacies In Disclosures 34

Test Your Knowledge 40

Final Exam Copy 49

Glossary 48

MANAGEMENT FRAUD

Chapter Objective

After completing this course, you should be able to:

- Recognize management fraud techniques as they relate to misstated financial statements.

The terms "management fraud" and "fraudulent financial reporting" are synonymous. The production of financial statements is the responsibility of management. Therefore, financial statement fraud almost always occurs with the knowledge or consent of management. Victims can be persons either inside or outside the company. Insiders who are possible victims include directors, managers, and employees who may suffer a loss of position, reputation or standing. Outside victims include investors, creditors, depositors, suppliers, customers, partners, underwriters, attorneys, and independent auditors.

Financial Statement (Management) Fraud Defined

According to Elliott and Willingham, financial statement fraud is management fraud:

> "The deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements."

The responsibility for detecting management fraud largely has fallen to the accounting profession. This responsibility has gradually increased over the years. Standards for independent auditors are set forth in Statements on Auditing Standards issued by the Auditing Standards Board of the American Institute of CPAs. These auditing standards deal almost exclusively with the problem of materially misleading financial statements (the organizational crime of management fraud) and very little with embezzlement and larceny (the occupational crime of employee fraud).

Why Financial Statement Fraud Is Committed

False financial statements are used to make a company's earnings look better on paper. False statements sometimes cover up the embezzlement of company funds. Financial statement fraud occurs through a variety of methods, such as valuation judgments and fine points of timing the recording of transactions. These more subtle types of fraud are often dismissed as either mistakes or errors in judgment and estimation. Some of the more common reasons why people commit financial statement fraud include:

- To encourage investment through the sale of stock

- To demonstrate increased earnings per share or partnership profit interests, thus allowing increased dividend and distribution payouts
- To dispel negative market perceptions
- To obtain financing, or to obtain more favorable terms on existing financing
- To receive higher purchase prices for acquisitions
- To demonstrate compliance with financing covenants
- To meet company goals and objectives
- To receive performance-related bonuses

This limited list of reasons shows that the motivation for financial fraud does not always involve personal gain to the managers. The cause of fraudulent financial reporting is the combination of situational pressures on either the company or the manager(s) and the opportunity to commit the fraud without the perception of being detected. These pressures are known as "red flags." If red flags indicating situational pressures and opportunity are present, the risk of financial reporting fraud increases significantly.

Examples of situational pressures include:

- Sudden decreases in revenue or market share experienced by a company or an industry
- Unrealistic budget pressures, particularly for short-term results
- Financial pressures resulting from bonus plans that depend on short-term economic performance

Opportunities to commit fraud generally arise from the lack of adequate oversight functions within the company. However, the existence of an oversight function does not, in and of itself, guarantee the detection of management fraud. The oversight functions must also respond effectively. The perception of detection is arguably the strongest deterrent to fraud. Some of the more obvious opportunities for management fraud are:

- The absence of, or improper oversight by, the board of directors or audit committee; or, the neglectful behavior of the board or committee
- Weak or non-existent internal controls, including an ineffective internal audit staff and a lack of external audits
- Unusual or complex transactions
- Financial estimates that require significant subjective judgment by management.

Financial Statement Schemes

In general, financial statement fraud occurs through (1) the overstatement of assets and income, and (2) the understatement of liabilities and expenses. Misleading statements can also be caused by (3) false or omitted disclosures in notes to financial statements. These misstatements produce

higher earnings or partnership profit interests or a more stable picture of the company's true situation.

To demonstrate these over/understatements, the typical schemes can be put in nine categories. Because the maintenance of financial records involves a double-entry system, fraudulent accounting entries always affect at least two accounts and, therefore, at least two categories on the financial statements. While the nine areas described below reflect their financial statement classifications, keep in mind that the other side of the fraudulent transaction exists elsewhere. It is common for schemes to involve a combination of several methods. The nine general classifications are:

1. Improper revenue recognition–form over substance
2. Revenue recognition in the wrong period
3. Improper sales accounting
4. Improper percentage-of-completion accounting
5. Inadequate disclosure of related party transactions
6. Improper asset valuation
7. Improper deferral of costs and expenses
8. Inadequacies or omissions in disclosures
9. Omission of expenses, losses, and related liabilities

IMPROPER REVENUE RECOGNITION

Improper revenue recognition—form over substance—involves sham transactions made to enhance the reported income or per share earnings. A common scheme in this area is less-than-arm's-length transactions. These transactions will falsely enhance the ordinary earnings of a company. This scheme can occur in a single year or over several years.

Less-Than-Arm's-Length Transactions

These transactions can be particularly difficult to detect because they generally require a co-conspirator's participation. Potential co-conspirators can be inside or outside the company, an affiliated or non-affiliated company, or a related or non-related party. Generally, the co-conspirators receive some benefit from the less-than-arm's-length transaction.

Example of Disclosure Deficiency for Insider Benefit

Informix Corporation was in the business of developing and selling office automation and database software. Informix merged with Innovative Software ("Innovative") whereby Innovative became a wholly-owned subsidiary of Informix. In their complaint, Klein v. King, (D.C. Northern California, No. C 88 3141), the plaintiffs alleged that the officers and directors failed to disclose material adverse facts regarding the company's business operations, both prior to and following the merger, and that it failed to make full, complete and timely disclosure of problems affecting its management earnings, sales, marketing, product development, and financial controls. These non-disclosures adversely affected the potential success of the merger. As a result of the allegedly false and misleading statements prior to the merger, Informix common stock traded at artificially inflated prices.

The purpose of the inflated prices, as alleged, was to enable the officers and directors of Informix to sell substantial holdings (1.8 million shares) for proceeds in excess of $36 million and allow the merger to be accomplished. The plaintiffs further allege that subsequentto them erger, the twocompanieshad difficultyinteg rating their operations, and management delays occurred in releasing new software programs.

REVENUE RECOGNITION IN WRONG PERIOD

Revenue recognition in improper periods typically involves (1) early booking, (2) holding the books open, and (3) untimely accounting for discounts and returns.

Early Revenue Recognition

Generally accepted accounting principles state that revenue should be recognized when the transaction is essentially complete. In the case of sales, the proper date is the one on which the risks and rewards of ownership pass to the purchaser.

The risks and rewards include possession of an unrestricted right to the use of the property, title, assumption of liabilities, transferability of ownership, insurance coverage, and risk of loss.

In the case of services, revenue should be recognized when the services have been completed and the seller has incurred substantially all the costs. A buyer's acceptance of services rendered is not a requirement, unless the acceptance is a condition of the services themselves which would lead to the argument that the services are not "essentially complete." Therefore, a dispute regarding the quality of services, which arises after the services have been rendered, does not preclude the revenue recognition. However, a dispute may cause the recognition of a liability or reserve against the revenue.

Example of Early Revenue Recognition

Time Energy Systems, Inc. developed, promoted and marketed energy conservation systems–hardware and software for managing energy use in buildings. The company, in its capacity as general partner, formed limited partnerships to raise capital for its operations. The limited partnership interests were sold with the idea of using the funds to purchase equipment from Time Energy (the corporate general partner). However, Time Energy supposedly needed to show profitable operations for two reasons:

(1) to induce investment in the limited partnerships, and

(2) to obtain bank financing.

Since the limited partnerships were Time Energy's primary customers, the company had few other sales to show for its profitability. Therefore, Time Energy charged management and incentive fees from research and development contracts to the limited partnerships, presumably for services rendered. Time Energy, however, recognized the fee income before performing the services and also failed to recognize an accrual for future costs of providing the services.

In addition, the limited partnerships borrowed money from outside lenders (banks) and from two of the officers of Time Energy. The borrowed funds were used to pay the management and incentive fees to Time Energy acting as the general partner. When limited partnership interests were purchased, the proceeds of those sales were used to repay the loans to both the banks and to the two officers. Therefore, Time Energy created income for itself through prepaid management and incentive fees (for services not yet rendered), using borrowed money which was later repaid by limited partners' capital contributions. The SEC filed an enforcement action against both Time Energy and its accountants.

The SEC said income was overstated because sales and fee revenues were recognized early, expenses were not accrued, and related-party transactions with the partnerships were not disclosed properly.

Source: Securities Exchange Commission, SEC v. Time Energy Systems, Inc., et al., Civil Action No. 86 1370 (D.D.C.), Litigation Rel. No. 11106, Accounting and Auditing Enforcement Rel. No. 99

Early Booking

Early booking of revenue can take several forms. A company may record anticipated sales and create invoices for the sales. Sometimes the schemes can be very sophisticated, as in the Electro-Catheter Corp. case.

Example of Early Booking

Electro-Catheter Corp. at one time had a normal accounting policy of recognizing sales revenue when merchandise was shipped. At the time the sale was recognized, the customer was billed, and inventory was relieved. The Company changed its policy and began recording sales and cost of sales when customers placed orders. For a two-year period, the Company allegedly overstated its income by approximately $4.5 million as a result of this new policy.

The company's policy was supposedly a "bill and hold scheme," whereby the Company recognized income in periods earlier than warranted. Sometimes the "bill and hold" policy was executed upon receipt of a distributor's order for a dollar amount of goods prior to the distributor identifying which merchandise was to be shipped. (Consequently, it was impossible to relieve inventory because the type of merchandise was not yet identified.) In some cases, shipment did not occur for over one year after the revenue was recognized.

Electro-Catheter Corp. had not passed any of the merchandise ownership rights after the institution of the new "bill and hold" policy. The company retained title to the merchandise, even commingling the goods with other inventory and allowing the customers the right of exchange. Electro-Catheter bore the storage and insurance expenses associated with the merchandise. The company maintained all the risk with respect to the decline in market value because the customers had merely identified a dollar amount and not the specific product mix in their orders.

Source: Securities Exchange Commission, Electro-Catheter Corp., Robert I. Bernstein and John J. Teryilan, Civil Action No. 87 0267 [NHJ] (D.D.C.), Litigation Rel. No. 11803, Accounting and Auditing Enforcement Rel. No. 196

Holding the Books Open

Holding the books open occurs when sales made after the end of the accounting period are nevertheless recorded in the accounting period. In some cases, the sales are real; in others they are fabricated. In service industries, the services may be performed in the next period, or not at all.

Untimely Accounting for Discounts and Returns

Indirect methods can be used to overstate net sales. These methods do not involve the overstatement of gross sales, but instead an understatement in the accounts which reduce gross sales to net sales. For example, an understatement of discounts, returns, and allowances will artificially inflate net sales. The two basic schemes involve failing to mark down discounts on merchandise when sales are made and failing to record returns.

Example of Untimely Discounts

Endo-Lase Company competed well in the market for scientific products by offering discounts and credits to its customers. However, the company allegedly billed customers at list prices, taking off the discounts and credits when the customers paid the net amount due. No estimates of credits and allowances were booked prior to collection. Thus, receivables and sales were overstated until the receivables were collected. As business expanded, so did the overstatement.

Source: SEC v. Michael Clinger, Walter G. Solomon and Avi Oren, Accounting and Auditing Enforcement Rel. No 142

IMPROPER SALES ACCOUNTING

Classifying certain transactions as sales can take a wide variety of forms, from fictitious sales to booking loan proceeds as income. Any increase (credit) to sales can come from a legitimate as well as a non- legitimate source. Schemes involving the improper treatment of sales are designed to overstate or inflate sales.

Fictitious Sales

Fictitious sales most often involve fake or phantom customers. However, fictitious sales can involve legitimate customers. For example, an invoice can be prepared for a legitimate customer with no shipment of goods. At the beginning of the next accounting period, the sale can be reversed. This is a fictitious sale coupled with a spurious bill and hold scheme. Another method of utilizing legitimate customers is to artificially inflate or alter an invoice to reflect higher prices or quantities.