PacificCPE

COURSE
11651A

Detecting and Analyzing Financial Statement Fraud

Financial statement fraud costs organizations billions each year, and CPAs are often the first line of defense. This course covers the fundamentals of disclosure fraud, how fraudulent financial statements are constructed, and the analytical techniques used to uncover them. You'll explore both qualitative financial statement analysis and quantitative ratio analysis to identify red flags and anomalies. Whether you work in audit, accounting, or advisory services, this course builds a strong foundation for recognizing and responding to financial reporting manipulation.

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

Start Course ↓

Final Exam Copy ↓

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

- Recall various types of disclosure fraud.
- Identify methods for detecting financial statement fraud.
- Recall analytical techniques to detect fraud.
- Recognize various ratio analysis tools.

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: August 2025

TABLE OF CONTENTS

CHAPTER 01

Disclosure Fraud 5

1.01 Categories Of Disclosure Fraud 6

1.02 Common Disclosure Risks 7

Test Your Knowledge 14

CHAPTER 02

Detecting Financial Statement Fraud 18

2.01 Motives For Financial Statement Fraud 19

2.02 Fraud Risk Indicators 21

2.03 Internal Control Indicators 21

Test Your Knowledge 27

CHAPTER 03

Financial Statement Analysis 30

3.01 Use Of Analytical Techniques To Detect Fraud 30

3.02 Horizontal Analysis 30

3.03 Vertical Analysis 32

3.04 Budget Variance Analysis 33

Test Your Knowledge 35

CHAPTER 04

Ratio Analysis 37

4.01 Research On Ratio Analysis 37

4.02 Use Of Operating Ratio Analysis To Detect Financial Statement Fraud. 38

4.03 Another Useful Measure: Working Capital To Total Assets 47

Test Your Knowledge 48

Final Exam Copy 51

Index .....

Chapter 1: DISCLOSURE FRAUD

Chapter Objective

After completing this chapter, you should be able to:

- Recall various types of disclosure fraud.

Prior to reading any financial statements, readers should always consider the valuable information provided in the notes to the financial statements. The same can be said for fraud investigators – study the notes. The notes may be a source of a financial statement fraud, but they may also provide useful clues about other fraud that affects amounts reported in the financial statements.

A thorough description of the disclosure requirements, and the associated red flags of fraud, would require a voluminous text of its own. So, the approach taken in this course is to provide a framework for evaluating note disclosures and to explore only a handful of the most likely suspects in the category of disclosure fraud.

There are four general types of notes that can be found in the financial statements:

1. **Policies.** Many of the notes, usually some of the first ones following the core financial statements, provide information about the accounting policies and methods used in preparing the financial statements. These notes provide answers to some of the most important questions associated with evaluating statements for the risk of fraud. For instance, what inventory flow model does the company utilize? For which assets has an election been made to carry at fair value? What are the ranges of useful lives used in depreciating and amortizing property and equipment and intangible assets? What methods are utilized in the recognition of revenue?
2. **Composition of accounts.** The notes often provide details of amounts that appear as a single line item in the core financial statements. For example, a line item "Investments" appearing on the balance sheet may be associated with a note disclosure listing the categories and amounts of investments held, such as equities, fixed income securities, and so on. Some accounting standards are rather specific regarding the level of detail that must be disclosed, while others provide more general guidance, such as by stating that an "appropriate" level of useful disaggregation should be disclosed in the notes. Another example of this type of disclosure is the schedule of future maturities of long-term debt.

3. **Additional information about items in the statements.** In addition to further quantitative data about items in the financial statements, the notes are also used to provide descriptive information about certain amounts. For example, a long-term debt note should also provide a description of any collateral associated with loans. An important disclosure in this category pertains to related party transactions. Another important category of disclosures in this area is for changes in accounting methods and changes in accounting estimates.
4. **Information about items not in the financial statements.** Certain disclosures are required for information that does not relate to a specific amount reported in the financial statements. This is particularly true in the case of commitments that an entity has at the end of the year. In addition, important events that occur after the balance sheet date (the last day of the entity's reporting period) but before the date of the auditor's report (which coincides with either the date the financial statements were issued or the date the statements were available to be issued) must be disclosed.

As each line item or section of the financial statements is reviewed, the corresponding sections of the notes should be read carefully. Keep in mind that the notes themselves may be fraudulent or they may provide clues as to a fraud that directly affects certain line items of the financial statements.

CATEGORIES OF DISCLOSURE FRAUD

Disclosure frauds can be classified in the following manner:

- **Omissions.** Failing to disclose information required by an accounting standard represents a departure from U.S. GAAP or IFRS. Most commonly, omissions involve some negative piece of information, such as failure to disclose pending litigation against a company, the subsequent financial troubles of a major customer, or other information that would cast an adverse light on the entity.
- **Incomplete disclosures.** Certain issues are too public or too important to avoid altogether. So, an unscrupulous company may try to soften any negative publicity by leaving out a few important details, or by leaving out a negative aspect of an otherwise positive event.
- **Misrepresentations of information presented in the notes.** Some notes to financial statements contain outright inaccurate information.
- **Confusing disclosures.** While confusing descriptions provided in the notes may not be a fraud itself, it is often a sign of some underlying fraud or of an omission of information.

A useful technique in evaluating the risk of financial statement fraud is to compare the notes in the current year financial statements with the notes of the prior year. Look for changes from one year to the next. Each of the following disclosures can provide clues regarding financial reporting fraud risks:

- Changes in accounting estimates (useful lives of depreciable assets, estimates of uncollectible accounts receivable, fair value estimates, etc.)
- Changes in accounting methods (methods of depreciation, revenue recognition, methods used in measuring fair values of assets, etc.)
- Changes in descriptions of the nature of a company's operations (e.g., disclosures of new or discontinued products, opening of new locations, etc.)
- Notes indicating acquisitions or dispositions of affiliates or lines of business

COMMON DISCLOSURE RISKS

The remainder of this chapter will be devoted to explaining some examples of disclosures that tend to be the most vulnerable to fraud. There are many disclosures required under U.S. GAAP and IFRS. A complete discussion of fraud risks associated with each required disclosure would fill a large text of its own. So, the approach in this course is to focus on some specific risks that illustrate a few of the most common disclosure frauds, starting with an example of the most common type – the omission of required disclosure data.

Loss Contingencies

The primary reason for omitting a required disclosure is that the disclosure would provide negative information to the readers of the financial statements. For example, the requirement to accrue liabilities for certain loss contingencies was explained. However, as noted, not all loss contingencies are required to be recorded as liabilities. Some contingencies that are not recorded are instead disclosed in the notes to the financial statements. There are two situations in which loss contingencies that are not required to be accrued must be disclosed in the notes:

1. Loss contingencies that have at least a reasonable possibility of occurring
2. Cases in which an exposure to loss in excess of the amount accrued exists and there is at least a reasonable possibility of this additional loss being incurred

In either of these cases, a company should disclose the nature of the loss contingency and an estimate of the possible amount of the loss, or a range of losses if that cannot be determined.

Commitments

Unlike a contingency, a commitment represents a known obligation normally associated with a future outflow required under an existing contract or lease. For example, minimum future lease obligations must be disclosed in the notes, even though this liability is not reported on the balance sheet (unless certain criteria are met, and the overall treatment of leases is currently in the process of undergoing change).

An example of a failure to disclose a commitment is included in the case involving Vivendi Universal, S.A., a French company whose financial statements were prepared in accordance with French GAAP, but also included U.S. GAAP-based disclosures. Vivendi had stock traded on the EuroNext Paris, S.A. as well as on the New York Stock Exchange during the time covered by this case, from 2000 to 2002.

Among a series of charges against Vivendi was the allegation that the company failed to disclose a major commitment. The commitment originated in February 2001, when Vivendi and the Moroccan government allegedly entered into an agreement that required Vivendi to purchase shares of Maroc Telecom, a Moroccan telecommunications operator, in February 2002 for approximately €1.1 billion. In 2000, Vivendi had acquired a 35 percent interest in Maroc Telecom. This additional commitment to acquire an another 16 percent interest was not disclosed in Vivendi's financial reports filed in 2001 and early 2002.

Related Party Transactions

As noted in other sections of this course, transactions with related parties are often susceptible to misstatement. In fact, the concern over the reporting of related party transactions has risen to the point that in February 2012, the PCAOB proposed a new auditing standard focused solely on the evaluation, accounting, and disclosure of related party transactions.

These transactions require separate disclosure in the notes to the financial statements. An exception from disclosure applies under U.S. GAAP for compensation paid to related parties. This exception does not apply under IFRS, and IAS 24 specifically requires disclosure of compensation and benefits provided to related parties.

ASC 850 requires disclosure of material related party transactions, including all of the following:

1. Nature of the relationship
2. Description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each period for which income statements are presented

3. Such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
4. Amount of the transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
5. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

IAS 24 requires disclosure of the nature of related party transactions, as well as amounts of the transactions and amounts of outstanding balances at year-end.

A significant majority of public companies (75 percent in a 2003 Wall Street Journal study) disclose the existence of related party transactions. Most of these disclosures are fully compliant with the accounting standards. So, the challenge, then, is to weed out the inaccurate disclosures. Even more challenging is the detection of omitted disclosures.

The most common disclosure fraud risk associated with related parties is the failure to disclose transactions with these parties. Secondarily, misrepresentations regarding the nature of the related party or incomplete disclosures pertaining to the nature of related party transactions are additional risks.

Two cases provide illustrations of how fraud in the form of non-disclosure is carried out. A fascinating case involving allegations of failing to disclose related party transactions is that of the Anglo Irish Bank and loans made by the bank to the chair and another member of its board of directors. As expected, Anglo Irish Bank disclosed its “Loans to Directors” in its year-end financial statements. However, loans estimated at €87 million at the end of fiscal year ended September 30, 2008 were not disclosed. The reason – shortly before year-end, the loans were paid off, usually by transferring them to another entity. Then, immediately after year-end, the loans were transferred back onto the books of Anglo Irish Bank. This temporary removal of related party balances, which purportedly took place from 2000 to 2008, might arguably meet an exception from disclosure of the balance at year-end. But, most experts would agree that disclosure of this practice and the existence of the transactions themselves should have been made in the notes to Anglo Irish Bank’s financial statements.

The scandal over Anglo Irish Bank’s circular transactions and failures to disclose began with the CEO’s admission in December 2008, but then progressed to nationalization of the bank in 2009 and additional investigations, including assertions that the auditors were negligent.

In May 2012, China Natural Gas, Inc. (CHNG) was charged with concealing the related party nature of two short-term loans totaling $14.3 million. CHNG is based in the People's Republic of China and is a distributor of natural gas through fueling stations owned by affiliates. In January 2010, CHNG made two loans totaling $14.3 million and reported the loans as being made to unrelated third parties. In fact, the beneficiary of both loans was a real estate company that was 90 percent owned by the son of CHNG's chairman and former CEO and 10 percent by a nephew. In one of the loans, an individual served as a sham borrower in order to conceal the true nature of the loan to the real estate company. In light of CHNG's total reported assets of just over $200 million, this failure to disclose the related party loans was considered to be a material misstatement of the financial statements. As part of the scheme, CHNG provided a fraudulent legal opinion from its legal counsel to CHNG's auditors as additional support for the assertion that the loans were to unrelated third parties when the auditors questioned the loans.

Changes in Accounting Principles

ASC 250 requires disclosure of the following in the financial statements of the period in which a change of accounting principles is made:

1. The nature of and reason for the change, including an explanation of why the newly adopted accounting principle is preferable.
2. The method of applying the change, including all of the following:
    a) A description of the prior-period information that has been retrospectively adjusted, if any.
    b) The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.
    c) The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
    d) If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change.