



What the construction industry should know about financial statement fraud - Part II

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Part II of III

This is Part II of a three-part series on fraud in the construction industry. Part I identified the three types of accounting fraud - asset misappropriation, corruption, and financial statement fraud while this part expands on the discussion of the various financial statement fraud schemes that are common within the industry. Missed Part I? Visit www.nyrej.com/69836 to catch up!

Financial statement fraud schemes typically involve the overstatement of assets and revenues, and the understatement of liabilities and expenses. In this case, the financial statements will reflect a balance sheet and income statement that show the company being financially healthier than it really is. Over time, if continually perpetrated but not detected and corrected, this artificial net worth begins to erode the liquidity, solvency, and ultimately the very existence of the company.

There are five types of financial statement fraud schemes, all of which are exacerbated by the necessity for the use of various estimates during the life of each long-term project. This article, will address three types of schemes and the remaining two will be addressed in Part III of the series.

In each case, as the objective is typically the overstatement of assets and revenues (understatement of liabilities and expenses), there are limitless incentives for a fraudster to understate the assets and revenues or to overstate liabilities and expenses. This discussion of the most common fraud schemes recognizes that the opposite objective may be achieved by a fraudster, depending on the circumstances of each case.

Fictitious Revenue

Recognition

This involves the recording of revenue that has not yet been earned. This is usually achieved through fictitious invoices, and the manipulation of the underlying construction costs upon which recognizable revenue is calculated using the percentage of completion method.

Typically, revenue is recognized when it is realized or realizable, and earned. In the construction industry, that is when the underlying work on a project has been performed and the related costs incurred are recognized. Long-term contracts present special problems for revenue recognition, where the cost-based percentage of completion method and the completed-contract method are typically the basis for revenue recognition.

Under the completed contract method, no revenue is recognized until the project is 100% complete; and, the related project costs are held as inventory. This method leaves little room for revenue manipulation.

However, the percentage of completion method recognizes revenue and costs as measurable progress milestones on a project. This method is vulnerable, as managers can easily manipulate the percentage of completion to recognize revenue prematurely and conceal contract overruns. The

following can be manipulated to affect revenue recognition:

- * Concealing subcontractor, labor and other project costs.
- * Subjective estimation of costs to complete the projects.
- * Shifting costs between projects.
- * Improper allocation of indirect overheads to projects.
- * Misallocation between project and non-project costs.
- * Improperly deferring project costs.
- * Premature expensing of pre-contract costs.
- * Commingling of project and other costs.
- * Recognition of unapproved change orders and claims that have no basis for inclusion in contract value.
- * Setting improper project milestones where cost-to-cost is the more appropriate basis.

The construction industry is unique in that the revenue recognized during the life of a project increases when contract costs increase as milestones are met. Revenue can therefore easily be manipulated in any direction by altering, concealing project costs, or shifting costs between various projects.

Timing Differences

This is the premature recognition of revenues and/or expenses in the improper financial periods. This overstates the financial results of one period and understates those of the preceding or succeeding period.

Financial statement fraud may also involve timing differences, that is, the recording of transactions (typically expenses) in improper periods. The fraudster's objective in this case is to shift revenues or expenses between one period and the next and increase or decrease earnings as desired.

Improper Asset

Valuations

This scheme inherently relies on estimates of value if the original cost of the asset is impaired. Whenever estimates are used, there is a high risk of fraudulent manipulation.

Earnings can also be manipulated through the improper recognition of asset values. With the exception of certain securities and assets held for sale, assets are generally valued at the lower-cost or their market value. When an asset's cost exceeds its current market value at the balance sheet date, which frequently happens with inventory, receivables, and other property and equipment, the asset must be written down to its lower market value. Determining market value lends itself to fraudulent use of estimates. The assumptions, basis and logic underlying these estimates can be manipulated and justified to achieve a desired asset value, and earnings amount.

Many of these schemes are used to inflate current assets at the expense of long-term assets, thus overstating the contractor's working capital position and deceive current or potential lenders who often require the maintenance of certain financial ratios.

The assets that are misclassified in this manner are typically:

- * Inventory on the job site: Fictitious inventory schemes usually involve the creation of fake documents such as inventory count sheets and receiving reports.
- * Contract receivables: The two most common schemes involving accounts receivable, which generally occur around the end of the accounting period, are the recording of fictitious receivables or the failure to write-off bad debts or adequately reserve for accounts of doubtful collectability.
- * Property and equipment: Fixed asset values can be manipulated through the booking of fictitious

equipment, misrepresenting asset values, improperly calculating the depreciation expense and charging it to project costs, and the improper capitalization of inventory and start-up costs.

* Goodwill: During business acquisition, companies are required to allocate the purchase price paid to acquire another business to the assets of that entity, and in the process recognize goodwill. That allocation process lends itself to the manipulative allocation of asset values and valuation of goodwill.

The fourth and fifth types of financial statement fraud schemes (concealment of liabilities and expenses, and improper disclosures) will be discussed in the third and final part of this series. Part III will also discuss the various red flags, and/or "risk factors" that could indicate a construction company's increased vulnerability to financial statement fraud.

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