# *Financial Statement Fraud: Strategies for Detection and Investigation*

*By Gerard M. Zack, Wiley, November 2012, ISBN: 978-1-118-30155-5, 288 pages, $85.00 hardcover, $59.99 e-book*

*Reviewed by Vincent J. Love*

This book is an outstanding compilation of many types of financial reporting fraud, including an analysis of the underlying schemes and real-life examples to demonstrate their machination and evolution. Throughout the book, Zack uses plain English to explain the relevant standards under U.S. GAAP and IFRS that are ignored or distorted by those committing the fraud. In fact, the book is so well written that even nonaccountants can understand the important elements of the standards. Standards under both accounting frameworks are referenced to their source, allowing readers to delve further into the underlying accounting if they desire to do so. Whenever a standard is being evaluated and could change, whether under GAAP or IFRS, Zack alerts readers of exposure drafts or proposed changes.

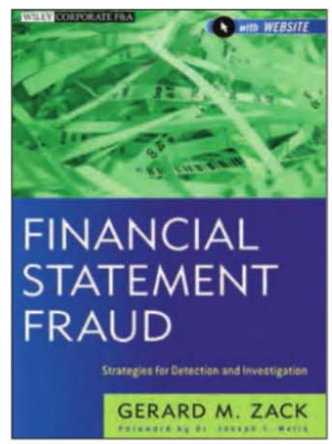
The author also points out the significant differences between GAAP and IFRS in each instance where they are cited and explained. This is particularly helpful in fraud cases that involve recording and measuring financial assets, debt, contingent liabilities and business combinations, and pension plan accounting. Intricate accounting practices are described in a readable way. Although the book will not make the reader an expert, it will educate the reader who is not an accountant or has not worked with a specific standard sufficiently enough to understand the mechanics of the fraud scheme.

The examples provided throughout the book are extremely useful in portraying to readers the real-life essence of a fraud scheme. The author references the Accounting and Auditing Enforcement Release (AAER), which allows readers to delve further into such real-life examples if they choose to do so. One might have expected the inclusion of citations to give a "textbook" tone to the book, but it certainly has not, which is arguably attributable to Zack's flowing, novelistic style.

## Types of Fraud Schemes

This book is divided into five parts, each of which addresses a different type of fraud scheme.

***Part I.*** This section is devoted to revenue-based schemes—the most prevalent type of material financial statement fraud. The author takes readers through revenue recognition principles, sorting fraud schemes used to increase revenue into basic categories, each of which are discussed in one of the section's four chapters. For example, chapter 2 focuses on timing schemes; the author describes delayed shipment schemes and provides examples of its use. In this case, the author uses the Sensormatic Electronics Corporation case, in which carriers were instructed to delay shipments to meet a customer's expectations that the goods would be shipped in the subsequent quarter. Sensormatic recorded the sale in the current quarter—a variation of the "ship and hold" scheme (addressed later in the chapter) that Sensormatic also used.




Percentage-of-completion schemes are also described, with examples given to drive home the point that these schemes are real and are sometimes used by companies to fraudulently inflate their revenues and earnings. The book covers just about every scheme used in this category of fraud. "Channel stuffing" is one scheme for which the author gives a number of real-life examples—including Bristol-Myers Squibb, McAfee, Krispy Kreme Doughnuts, and ClearOne Communications.

Other chapters of this section address fictitious and inflated revenue schemes, misclassification schemes, and gross-up schemes. In one interesting analysis, Zack shows how the gross-up scheme can change financial statement analytical percentages by including the amounts from incentive schemes in different classifications on the income statement. Throughout all of these examples and analyses, the author's style engages the reader, and he uses language that both professionals and laymen can easily understand.

***Part II.*** In this section, Zack addresses asset-based schemes under different categories of fraud—improper capitalization of costs, asset valuation schemes, and fair value accounting. In chapter 6, he discusses improper capitalization of costs, lists eight areas in which this type of fraud scheme is most likely to be used, and then covers each area in enough detail to demonstrate the underlying scheme and how it is implemented. Although the book does refer to the well-publicized example of WorldCom, it also looks at a much less known fraud at the American Italian Pasta Company. This enterprise used a number of asset-based schemes to inflate its earnings over the 2002–2004 period. It used three different methods to overcapitalize the installation of new pasta production lines. Other schemes used were to capitalize 1) manufacturing expenses that exceeded a budgeted amount, 2) the net effect of the impact of sales shortfalls on profits, and 3) internal and external information technology costs that are not properly capitalizable.

The remaining chapters in this section dissect asset valuation schemes, fair value accounting, shifting expenses to future periods, and omissions and underreporting of liabilities. Of note is the author's introductory sentence to the section dealing with assets acquired from related parties: "Some of the most egregious cases of overvaluing assets either purchased or obtained in barter transactions involve acquisitions from related parties" (p. 92). He then goes on to briefly but informatively mention Tyco and Enron, probably the two most widely publicized frauds involving related-party transactions, among other schemes.

***Part III.*** This section looks at expense and liability schemes, which include shifting expenses to future periods and the omitting or underreporting of liabilities. What is unique to these schemes is that they relate to fraud that is not recorded on the enterprise's books, rather than a misstatement of something that has actually been recorded.

***Part IV.*** Other financial reporting schemes—that is, the types of frauds that are initiated in connection with other economic events affecting an enterprise—are discussed in this section of the book. These schemes are perpetrated in conjunction with consolidated financial statements, business combinations, concealment of asset misappropriation and illegal acts, and disclosure fraud. Also mentioned are frauds that are somewhat unique to not-for-profit organizations, including the misclassification of expenses, which can affect federal grants and restricted contributions. Analyses of embezzlement and bribes are also found here.

The author devotes an entire chapter to disclosure fraud. The chapter's introduction recognizes the importance of reading the notes to the financial statements, which have important information needed to properly assess the financial strength of an enterprise. Disclosure fraud is classified into four categories: omissions, incomplete disclosures, misrepresentation of information presented in the notes, and confusing disclosures. The disclosure requirements and schemes are explained in the same easy-to-read style used throughout the book.

***Part V.*** This section covers the detection and investigation of fraud. COSO's *Internal Control–Integrated Framework* is discussed; the book lacks discussion of the revised framework, which was issued after publication, but it does not suffer as a result. Zack succinctly lays out the characteristics of the fraudster and the motivations underlying the fraud act. The chapters on using financial statement analyses, including ratio analyses and other techniques, to search for fraud in financial statements are heavier reading than the chapters describing the different fraud schemes, but they are well structured and packed with good analytics. But the chapter on assessing (or minimizing) auditor liability seems out of place, because the author does not discuss financial statement fraud that includes auditor participation.

## Other Resources

The appendix, "Financial Statement Fraud Indicators," is a great compilation of conditions that could but do not necessarily point to fraud. But the first condition under revenue-based schemes—"Cash flows from operations are negative or lag significantly behind reported income"—while generally true, did not exist in the Enron fraud because of how it was conducted. Enron's fraud, in many instances, "created" current cash for operations. This only goes to prove that clever frauds can be hard to find; however, understanding and using the indicators in this appendix will greatly assist in uncovering material fraud or errors in financial reporting.

The book also includes a reference to a companion website that contains copies of public documents relating to the examples used in the book and the password to access the site.

## A Worthwhile Read

*Financial Statement Fraud: Strategies for Detection and Investigation* by Gerard M. Zack is a great, worthwhile read. It can be purchased in print or downloaded as an e-book for convenient reading while commuting via public transportation. It is a pleasure to read and is loaded with great insight and information on fraud. For anyone interested in fraud and its detection, this book reads like a novel and is worth the investment in time and money; readers will not be disappointed. ❑

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