

Do Your Financial Statements Add Up? If Not, Be Alert to Fraud

By Diane C.O. Gilson, CPA, CIA, President, Info Plus⁽⁺⁾ AccountingSM PC

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The seventh in a series about preventing fraud from affecting your business.

Don't make the mistake of having someone review your financial statements and management documents for you because you don't understand them or don't have the time to review them yourself. Thieves could be filching your assets and hiding the evidence in doctored documents.

Instead, insist on regularly receiving financial statements and management documents at a specific time each month. Then, take the time to become very, very familiar with them. This is the best way to spot something out of the ordinary and uncover fraud. (If necessary, ask your accounting advisors for some in-depth training in how to read and interpret them.)

Here's what to look for as you review the following documents:

Balance Sheet — Check It Very Thoroughly

The balance sheet basically states what you own (assets), what you owe (liabilities) and what is left over (equity) on a given date. Because business owners tend to focus on income statements, embezzlers often find it easier to conceal fraudulent activity in balance sheet accounts. This is one document you should check very thoroughly.

Pay close attention to what changes from period to period (i.e., accounts receivable, accounts payable, work in process, various loan balance accounts, fixed asset accounts, etc.). Determine which accounts should be increasing or decreasing and ask for supporting schedules. (Read the earlier article in this series, "[Review Your Accounting Reports to Protect Yourself From Fraud](#)," for some more details about balance sheet supporting schedules and change reports.)

Income Statement — Stay on Top of Cost Accumulations and Gross Profits

Fraudulent activity also can be hidden in an income statement, particularly in accounts with large cost accumulations (e.g., building materials, trade contractors, payroll, etc.).

Ask for income statement reports that show the most recent month's activity and year-to-date activity. The reports should include a "percentage of income" column that shows what percent of your income you are spending on each type of expense.

If your chart of accounts and accounting reports are properly structured, you will also be able to see the amount of [gross profit](#) earned and the related gross profit margin percentage. Make sure your income, direct costs and gross profit dollars and percentages are in line with your estimates and goals.

Overhead accounts (e.g., rent, telephone, accounting fees) generally have far fewer dollars flowing through them. Although they are typically less prone to fraudulent overcharges, you shouldn't overlook them.

Job Cost Reports — Beware 'Buried' Fraudulent Materials Costs

There are two basic types of job cost reports — account-based reports and job-stage reports — and they can easily hide fraudulent costs.

When you review a profit and loss by job (account-based) report, make sure the report's job cost accounts total agrees with your company totals for those same accounts. If totals don't agree, you will know that some costs have not been assigned to jobs and your individual job cost reports are not accurate. It is fairly easy for an embezzler to "bury" fraudulent materials cost in an account and never have it show up on a job cost report, so examine these reports thoroughly.

Once you are sure all job costs have been assigned to a job, look at your "job cost by job-stage" reports.

You may ask, "How could fraudulent activity be concealed in a detailed estimate vs. actuals by job-stage report if I've followed all of the previous balancing processes?" You will have to be creative to uncover the answer. After all, embezzlers are.

For example, what if your estimate included costs for something the client decided not to include, or if the cost of drywall decreased but your estimate didn't reflect the change? If an embezzler wrote a check to a phony supplier for the amount of the difference, would you spot it? Probably not; we're usually "wired" to look for variances. If the entries look normal, fraudulent costs easily can be overlooked.

What You Can Do Immediately

- Become an "informed consumer" of your company's financial information.
- Just as you "measure twice, cut once," look at your information from a variety of perspectives and angles.
- Do not assume that data is correct just because it's printed in an official-looking format. Probe and double-check different areas every time you review your financial statements and management documents.

Other Red Flags in Your Financial Reports That Can Alert You to Possible Fraud

- Numbers that don't add up or make sense to you
- Numerous, confusing entries (e.g., many "ins" and "outs," various "error corrections," etc.)
- Journal entries with no explanations or supporting documentation
- Income or expense accounts with numerous "netted" entries. Increases and decreases normally should be recorded in clearly labeled accounts at gross (e.g., discounts to customers should be posted in an account labeled "customer discounts")
- Balance sheet accounts with unsupported balances
- No periodic review, comparison against estimated or expected results, or accountability for specific accounts' correctness or balances
- Accounts with confusing or unclear names (e.g., "pending unearned receivable clearings" or "deposit application cancellations" or "suspense")
- Accounts that aren't sufficiently specific (e.g., "advertising")
- Missing documentation or support materials (e.g., original invoices, missing cancelled checks, etc.)
- Supporting documents are photocopied, not originals
- Bank accounts (or other balance sheet accounts) reconciled weeks or months late
- Reconciliations that don't agree with your books or with the bank's balance
- Old, outstanding checks removed from the books without discussion or approval (They may have they been converted to cash.)

Thoroughly investigate anything fishy and ask for supporting evidence. Ask about anything you don't understand. Don't just write off an unexplained loss as a one-time thing. Like fire, fraud only gets worse if it's allowed to spread.