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## **Concealed Liabilities and Expenses**

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### **The Scenario**

Auditors were conducting a financial statement audit for a DoD Agency. During the sample testing of accounts payable transactions, the auditors attempted to trace amounts to the accounts payable sub-ledger, and as they performed this procedure, the auditors noticed that not all invoices were recorded. Also, significant estimates of liabilities and expenses were difficult to corroborate.

To gather information and determine why the transactions were not recorded, the auditors interviewed management and asked the following questions:

- Who is responsible for recording transactions to the accounts payable sub-ledger?
- What are the standard operating procedures for recording transactions to the accounts payable sub-ledger?
- Who reviews the transactions to ensure they are recorded properly?

Inquires to management initially did not yield any answers. However, as the auditors performed walkthroughs and interviewed employees, they discovered that the liabilities and expenses were not recorded because the employees were instructed to omit the transactions from the sub-ledgers. Employees stated that management was seeking to enhance the agency's performance and its management of funds.

The auditors performed additional analytical procedures to identify other liabilities and expenses that were not recorded. Specifically, the auditors performed a search for unrecorded liabilities by completing a cut-off test that compared vendors' invoices, receiving documents, and cash disbursements to determine when the liability was actually incurred. The auditors identified 85 out of 120 transactions that were not recorded.

As the auditors approached management again with the evidence of concealed liabilities and expenses and the information provided by the employees, management acknowledged what had transpired. Management manipulated the financial reporting process by trying to conceal liabilities and expenses throughout the year.

**General Comments / Lessons Learned.** The easiest method to conceal liabilities and expenses is to simply fail to record them. Understating liabilities is one of the ways financial statements can be manipulated. When liabilities are concealed, equity, assets, and/or net earnings are inflated.

## **FRAUD INDICATORS**

- **Invoices are not recorded in the sub-ledger.**
- **Significant estimates of liabilities and expenses are difficult to corroborate.**
- **Management instructs employees not to record/omit transactions from the accounting sub-ledgers.**