Improper Revenue Recognition

The Scenario

Auditors were conducting a Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit (SAS 99) interview as part of a financial statements audit. During the interview, an employee from the accounts receivable department revealed she noticed that for the last two fiscal years, books were held open past the end of the accounting period to accumulate more sales. Also, there were unusually large sales that occurred within a few weeks of the end of the accounting period. Because of these circumstances, the employee believed that revenue was being improperly recognized on the agency's financial statements.

With that information, the auditors selected a sample of sales transactions from the sales journal, obtained supporting documents, and performed cut-off tests. Indeed, the auditors discovered that the books were held open past the end of the accounting period to accumulate more sales, and as a result, sales were recognized prematurely, or during a period prior to the one dictated by the Generally Accepted Accounting Principles (GAAP).

The auditors also examined the internal controls and concluded that one employee did not process the same transaction from beginning to end; they deemed the controls to be effective. However, further investigations proved that the internal controls were overridden by management. Management changed the timing of legitimate transactions by holding the books open past the end of the accounting period. Also, the supporting documentation for sales was out of numerical sequence and management did not make any efforts to locate missing documents.

Management could no longer tolerate the auditors' questions or persistence, and finally disclosed that the agency was under pressure to achieve targeted earnings and that management overrides occurred to increase the perception of the entity's revenue on the financial statements.

General Comments / Lessons Learned. Ongoing pressure on profit margins indicates pressure on management, which could ultimately lead to fraud in the financial reporting. When agencies get desperate to show earnings, sometimes they resort to fraudulent timing differences to show phony profits. If a sale is legitimate, but is posted prematurely, the red flag would be a GAAP violation by early recording of the sale. Improper revenue schemes give the appearance that the revenue recognition criteria, as described within GAAP, have been met and without further examination may not be detected.

FRAUD INDICATORS

- **Ongoing pressure on management to increase profits.**
- **Books held open past the end of the accounting period.**
- **Unusually large sales that occur within a few weeks of the end of the accounting period.**
- **Management override of the internal controls.**
- **Missing supporting documentation.**