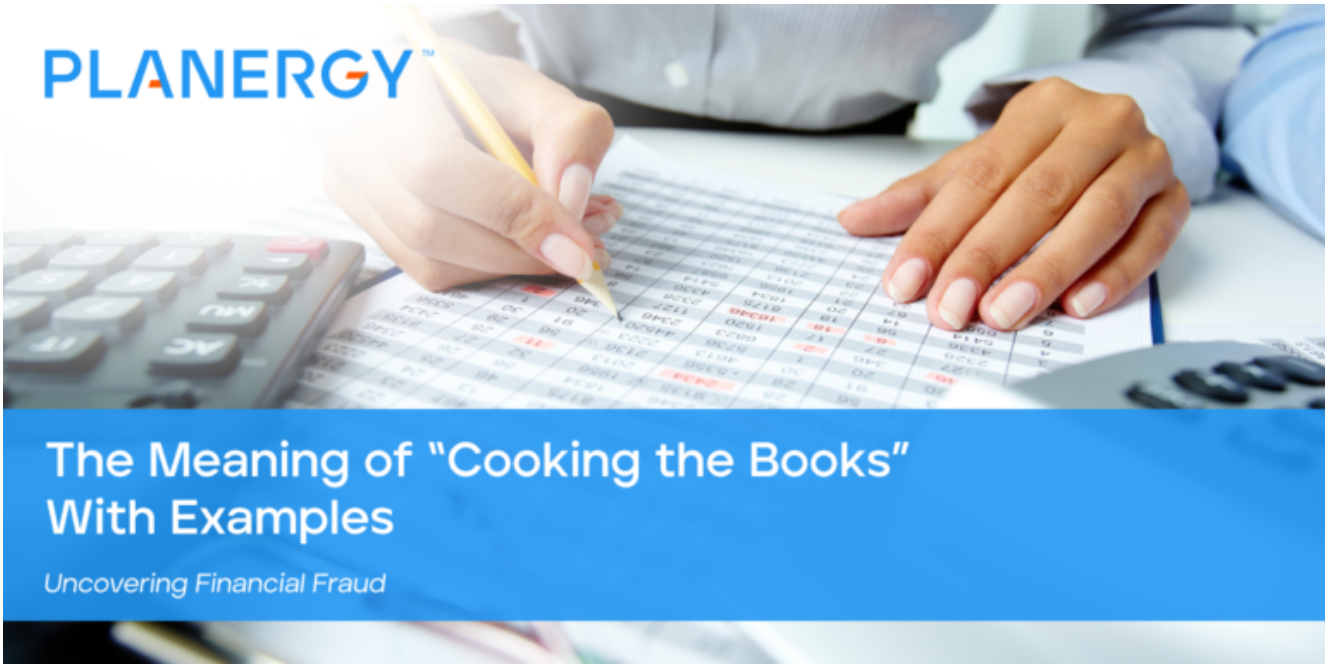
The Meaning of “Cooking the Books” With Examples



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We’ve all heard the phrase “cooking the books,” which refers to a business that knowingly falsifies financial information for their gain.

But what exactly does cooking the books entail?

We’ll explain exactly what the phrase means, and some common signs that businesses are cooking their books while providing you with some examples of ways companies cook their books.

What Is Cooking the Books?

Cooking the books is a slang term for using fraudulent activity to make a company's financial results appear to be better than what they really are.

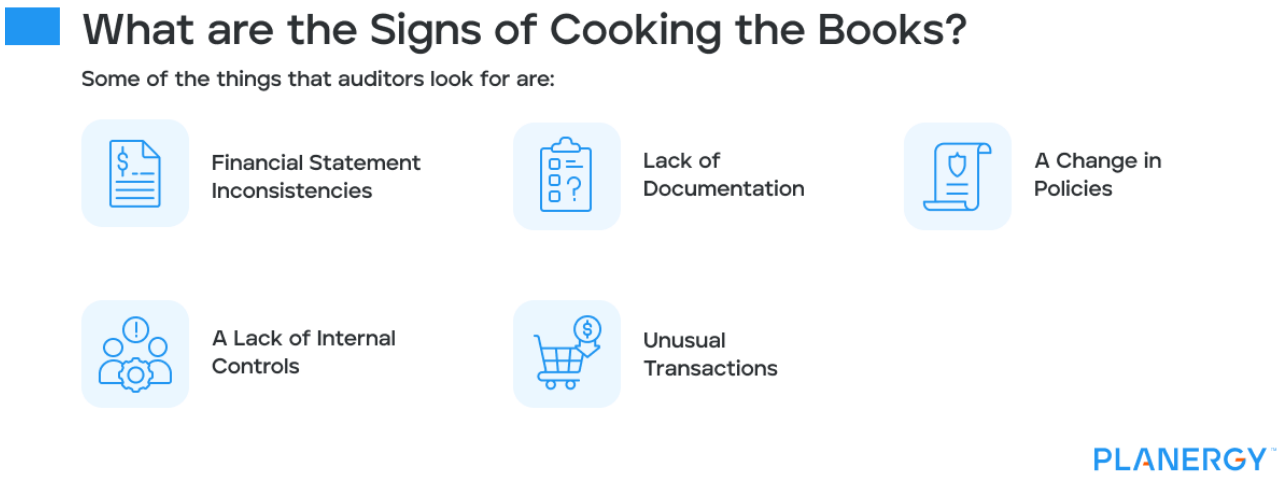
In most cases, cooking the books involves reducing expenses and/or increasing revenue.

But while the term may sound light-hearted, the reality is that cooking the books is financial fraud, which can carry very steep penalties, including prison time.

What Are the Signs of Cooking the Books?

Auditors are trained to spot red flags when examining your balance sheet and other financial statements.

Some of the things that auditors look for are:



Financial Statement Inconsistencies

Financial statements provide a comprehensive view of a company's financial health.

Not only do auditors look for unusual activity on financial statements, but they also look at previous statements to spot red flags such as a sudden increase in revenue or a sudden decrease in expenses.

In many cases, these increases or decreases may be legitimate, such as increased sales from a new product line or a decrease in rent by moving to another building.

But in many cases, this unusual activity signals something more going on behind the scenes.

Lack of Documentation

The lack of sufficient documentation is another red flag.

For example, when a large deposit is recorded in the general ledger, but there is no documentation to verify it, it may signal that a non-existent deposit was recorded to boost revenue.

Even if there is proof the deposit was made, if there's no corresponding documentation on where a deposit originates, the deposit should be investigated.

A Change in Policies

Another red flag that auditors look for is a sudden change in the way revenue is recorded.

For example, a company in the business of selling services may receive a payment from a customer for multiple years and decide to record it as earned revenue rather than defer it since it has not been earned.

Another policy change could be improper depreciation expense recording, delaying the recording of expenses to the next accounting period, or reclassifying accounts receivable balances to appear to be more recent.

A Lack of Internal Controls

One of the things that an auditor pays close attention to is how duties are segregated by the accounting department.

For example, they'll want to know if a single member of the accounting team handles most of the duties, or are the duties split between several

team members.

One single employee handling the majority of accounting tasks does not mean that anything fraudulent is going on, but it does send up a red flag that will be investigated.

- ### Unusual Transactions

  Payments made without a corresponding invoice, or a large number of cash deposits can also be seen as a red flag.

  Other activity that auditors look for is skimming or embezzlement, with financial statements altered to disguise the illicit activity.

  In all cases, any of these red flags should be fully investigated.

Breaking Down the Process of Cooking the Books

The process of cooking the books can be a simple act such as delaying the recording of expenses until the following year or posting revenue received for two years of services as current revenue, rather than deferring a portion until the revenue has been earned.

These fraudulent adjustments may be made in preparation for year-end closing if the business needs to show steady revenue to meet market expectations.

Some businesses also cook the books when the business is for sale to drive up the value of the business.

Whatever the motivation for cooking the books, accounting rules are in place for a reason, and it’s the legal and moral obligation of a business to follow those rules.

Common Ways To Cook the Books and

Examples

The following represents just a few of the ways that a company can cook their books:



- **Improper Revenue Recognition** – In accounting, revenue should be recognized when it's earned.
  For businesses that routinely receive revenue for products or services not yet provided, the revenue should always be deferred until it's been earned.

  For example, if ABC Roofing received a $2,000 check from their customer to pay for a two-year roofing maintenance contract, the revenue should ideally be recorded monthly for the next two years, not in one single lump sum, which artificially inflates your revenue totals for that accounting period.

- **Channel Stuffing** – This happens when a business sends unrequested products to a distributor, knowing that the product is likely to be returned, yet records the transaction as a product sale to increase revenue totals to meet market expectations.
- **Improper Expense Recognition** – If rising expenses will cause a company to miss market expectations, it may decide to adjust its financial statements by deferring expenses to the next accounting period or not recording the expenses at all.
- **Misleading Projections** – This happens when a business knowingly

omits to disclose a known risk.
For example, the value of company A rose six months ago when it disclosed that it was expanding into another region.

After months of negotiations, the company decided to not go through with the expansion, yet has not disclosed that information on any financial projections that they have released.

- **Stock Buybacks** – Stock buybacks are a common occurrence in the business world.
However, some businesses may decide to initiate a stock buyback to hide declining earnings per share since the number of shares outstanding will be decreased after the buyback, maintaining or even increasing dividends for the remaining investors.

- **Misclassification of Credit Sales** – When companies change credit terms for their customers, they can manipulate days outstanding results to make it appear that the outstanding revenue is current.

Regulations and the Ethical Dilemma of Cooking the Books

Cooking the books is neither legal nor ethical.

To better address fraudulent financial activity, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), which requires that senior officers certify their company's financial statements while complying with other regulations included in the act.

The Sarbanes-Oxley Act also created the Public Company Accounting Oversight Board or PCAOB, which is tasked with overseeing the accounting industry and its relationship with publicly held companies.

As a result of the PCAOB regulations, auditors of public companies are now required to register with the Board. In addition, CPA firms that audit public companies are prohibited from conducting business with the company(s) that they are auditing.

The Securities and Exchange Commission administers and enforces SOX and has an enforcement section that may prosecute corporate fraud cases in civil court.

Various state laws may also come into play when a corporate officer or other employee is accused of cooking the books.

Though privately held companies are not held to the standards of the Sarbanes-Oxley Act, they still have an ethical obligation to present company financial statements accurately.

While some may view cooking the books or white-collar crime as a victimless crime, those engaging in these acts are violating ethical principles and may face consequences ranging from termination to criminal charges.

The bottom line is that corporate fraud like cooking the books is a crime.

Any financial officer who approves fraudulent financial statements will likely face criminal charges which include costly monetary penalties and even prison time.

As we've seen in the past with businesses such as Enron, it's difficult for a company to recover from cases of fraud with many closings.

It isn't just criminal charges that can destroy a business.

A lack of ethics can directly contribute to the demise of a business. Individuals investing in your company, customers purchasing your products, vendors selling you products on credit, or financial institutions lending your business money all do so with a certain level of trust.

When it's revealed that CEOs, CFOs, or others have taken it upon themselves to share falsified financial data to present their business in a better light, they are destroying that trust.

Sales fall, investors leave, and loan money dries up, ultimately leading to a drop in stock prices and declining company valuation.

Once this happens, it's near impossible for businesses damaged by corporate fraud to recover.

Financial Compliance is the Key to a Successful Business

Committing to honesty and integrity isn't just a good idea; for publicly traded companies, maintaining and presenting accurate financial records to stakeholders is a requirement.

But even smaller, privately owned businesses have a responsibility to forego creative accounting and present both internal and external stakeholders with accurate financial statements that truly represent their business finances.

Committing to an automated system like PLANERGY can help reduce fraud by eliminating manual processes and centralizing the capture, organization, and analysis of all financial data making it easier to spot issues before they turn into a crisis.

While there are now safeguards in place to protect against a scenario like Enron's, it's impossible to police every business adequately, leaving it up to key personnel to implement the systems they need to ensure that their business remains fraud-free.

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