

FINANCIAL STATEMENT FRAUD:
DETAILED LOOK AT UNCOVERING
“CREATIVE” ACCOUNTING FRAUD:

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Definitions

- Financial statement frauds is the deliberate misrepresentation of the financial conditions of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.



Causes of Financial Statements Fraud

- Motivation for financial fraud does not always involve direct personal financial gain.
- The cause of financial statement fraud is;
 - Situational pressure on the manager or company.
 - Opportunity to commit fraud.



Situational Pressures

- Sudden decrease in revenue by a company or industry
- Financial pressures resulting from bonus plans that depend on short-term economic performance
- Unrealistic budget pressures particularly for short term results




Opportunity

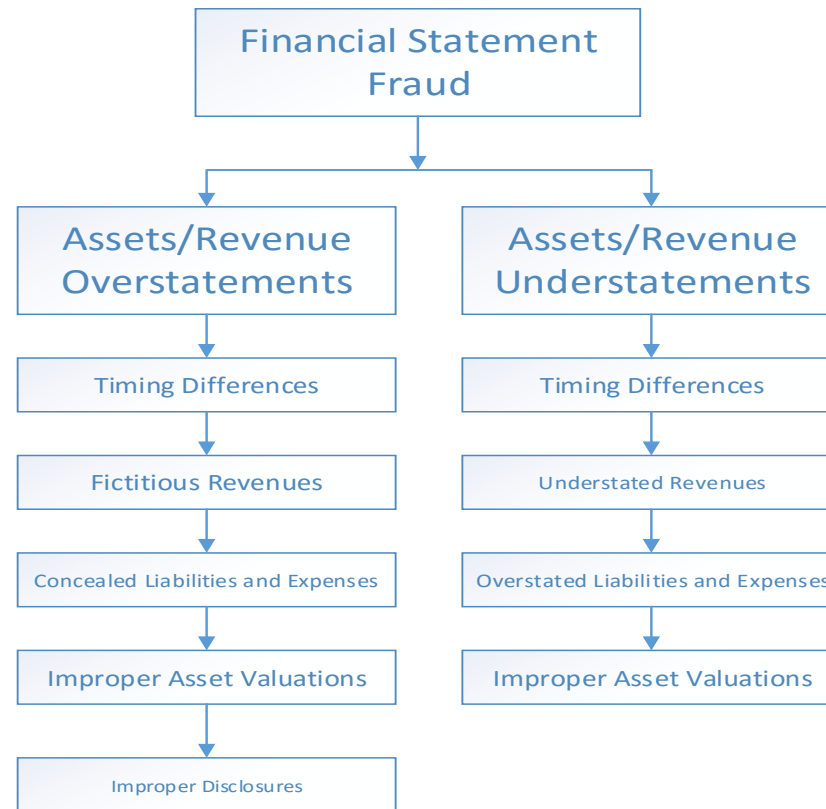
- Absence of a board of directors or audit committees
- Weak board of directors
- Weak or no-existent internal controls
- Ineffective internal audit staff and lack of external audits
- Unusual or complex transactions
- Financial estimates that require significant subjective judgment by management



Why Financial Statement Fraud is Committed

- We “cook the books” to “buy more time”. The main reasons are;
 - To quietly fix current problems
 - To obtain or renew financing
 - To inflate company share prices or exercise stock options at a profit
 - To obtain bonus pay linked to company performance
 - To encourage investment through the sale of stock
 - To demonstrate increased earnings per share thus allowing increased dividend payouts
 - To cover inability to generate cash flow
 - To dispel negative market perceptions
 - To receive higher purchase prices for acquisitions
 - To demonstrate compliance with financing covenants
 - To meet company goals and objectives
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Financial Statement Fraud Tree




Fictitious Revenues

- Recording of sales of goods that did not occur.
- This sale is reversed in the next accounting period.
- Sales with conditions. These are sales where ownership has not passed to the customer. They do not qualify for recording as revenue.



Red Flags of Fictitious Revenues

- Rapid growth or unusual profitability as compared to similar companies in the industry
 - Recurring negative cash flows or an inability to generate positive cashflows while reporting earnings and earnings growth.
 - Significant transactions with related parties
 - Special purpose entities not in the ordinary course of business
 - Significant unusual, or complex transactions especially close to the periods end that pose difficult “substance over form” questions.
 - Unusual growth in debtors days analysis
 - A significant sale to shell companies
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Timing Differences (Including Pre-mature Revenue Recognition)

- Recording of expenses or revenues in improper periods.
- Areas to look at on the above are;
 - Long term contracts
 - Channel stuffing
 - Recording expenses in the wrong period

Improper Asset Valuations

- Improper asset valuation take the form of one of the following classifications;
 - Inventory valuations
 - Accounts receivable
 - Business combinations
 - Fixed assets



Inventory Valuations

- Inventory should be recorded at the lower of cost or market value.
- Other methods include;
 - Manipulation of the physical inventory count
 - Inflation of the unit costs used to price out inventories
 - Creation of fictitious inventory e.g. manipulated stock count sheets
 - Reported large values of inventory in transit
 - Inventory with hollow centers
 - Shuttled inventory overnight from one warehouse to the other



Accounts Receivable

- Fictitious accounts receivable, these are common with companies with financial problems or from managers who receive commissions on sales.
- Failure to write off bad debts and to make provisions for bad debts.



Fixed Assets

- Recording fictitious assets by increasing assets and increasing owners equity.
- Creating fictitious documents.
- Recording leased assets as company owned assets.
- Misrepresenting the value of fixed assets -recording fixed assets at market value.



Fixed Assets Schemes

- Capitalising non-current assets
- Understate fixed assets-common in Government entities
- Misclassifying assets-reporting fixed assets as current assets, for loan / liquidity purposes



Liability/Expense Omissions

- Failure to post invoices
- Creating fictitious debit notes This is the easiest scheme to perpetrate and the hardest for debtors to detect.



Capitalised Expenses

- Capitalised expenses increases income and increases assets in the current accounting period. These expenses are then written-off over several years reducing future incomes.eg WorldCom.



Expensing Capital Expenditure

- This is done for purposes of reducing income thus reducing taxes.



Improper Disclosures

- Financial statements should include all necessary information to prevent any stake holder from being misled. The schemes here are;
 - Liability omissions-failure to disclose loan covenants or contingent liabilities
 - Subsequent events-failure to disclose court judgments'
 - Related-party transactions
 - Accounting changes
 - Failure to disclose unclaimed financial assets



Red Flags Associated with Improper Disclosures

- Domination of management by a single person or a small group.
- Ineffective board of directors or audit committee oversight over financial statements
- Lack of organisational code of ethics
- Formal or informal restrictions to the external auditor that limits them access to people and information.
- Complex organisational structure
- Significant bank accounts or branch activities in tax haven jurisdictions' which there appears to be no clear business justifications.



Detection of Financial Statement Fraud

- Financial statement analysis is done to detect major changes in financial statements so as to detect frauds. Major changes in the financial statements may indicate red flags in the financial statements. The main analysis to be made are;
 - Vertical analysis
 - Horizontal analysis
 - Ratio analysis



When an Investigation becomes Litigation

- Investigations are generally fact based engagements.
- Following the investigation, a litigation phase may ensue. This may be a criminal prosecution or, more typically, a civil action.
- The Forensic professional may appear as a witness of fact (in simple terms, to explain matters of fact arising from the investigation) or, more typically, as an expert witness (the expert witness role allows opinion evidence on matters of professional judgment in addition to factual evidence to be presented).



Integrating effective fraud risk management into the audit plan


- When obtaining reasonable assurance, an auditor maintains an attitude of professional skepticism (ISA 240) throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist. Due to the characteristics of fraud, the auditors attitude of professional skepticism is particularly important when considering the risk of fraud.
- Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- ISA 240 provides additional guidance on considering the risks of fraud in an audit and designing procedures to detect material misstatements due to fraud.



Integrating effective fraud risk management into the audit plan

- **Discussion among the engagement team** as required by ISA 315 “Understanding the entity and its environment and assessing the risks of material misstatements”.
- The discussion occurs with a questioning mind that address:
 - how and where audit team members believe the entity’s financial statements might be susceptible to material misstatements due to fraud, including consideration of known external and internal factors affecting the entity,
 - how management could perpetrate and conceal fraudulent financial reporting, and
 - how assets of the entity could be misappropriated.

Integrating effective fraud risk management into the audit plan

- **Inquiries of management** regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it.
 - The auditor should also inquire about any information reported by management to the audit committee about fraud risks and related controls.
 - Making inquiries of others within the entity, in addition to management, may provide auditors with a perspective that is different from management, and those responsible for the financial reporting process. (Internal audit personnel, operating personnel, in-house legal counsel, chief ethics, compliance officer, chief risks officer).
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Integrating effective fraud risk management into the audit plan

- The auditor should understand how **those charged with governance** exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and understand the internal controls to mitigate these risks.
- The audit committee often assumes an active role in overseeing management's fraud risk assessment and response processes.
- ISA 240 requires also the auditor to inquire whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.

Integrating effective fraud risk management into the audit plan

- ISA 240 requires the auditor to evaluate whether **fraud risk factors** exist that indicate incentives or pressures to perpetrate fraud, opportunities, to carry out fraud, or attitudes or rationalizations used to justify a fraudulent action.
- Fraud risk factors cannot easily be ranked in order of importance and the significance of fraud risk factors varies in assessing the risks of material misstatement.
- Size, complexity and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors.



Integrating effective fraud risk management into the audit plan

- **Analytical procedures** performed during planning may be helpful in identifying unusual or unexpected relationships or events that might indicate material misstatements, involving particularly revenue accounts.
- The auditor ordinarily presumes that there are risks of fraud in revenue recognition and considers which types of revenues may give rise to such risks. The comparison of sales volume based on recorded revenue with actual production capacity could reveal revenues beyond the capacity.



Performing Fraud Risk Assessments



Stages of the Fraud Risk Assessment

1

Plan

Confirm goals and schedule

2

Assess

Assess current state of fraud risks

3

Respond

Identify strengths, gaps, and recommendations

4

Report

Present findings and finalize report with recommendations

Continuous coordination between management and assessment team

- ▶ Assemble the proper team, considering:
 - ▶ Key stakeholders
 - ▶ Technical expertise
 - ▶ Industry knowledge
- ▶ Understand the fraud risk universe
- ▶ Communicate the goals of the assessment to the organization

- ▶ Conduct interviews
- ▶ Lead facilitated sessions
- ▶ Distribute questionnaires and surveys
- ▶ Identify fraud risks present in the organization
- ▶ Assess the potential impact of the identified risks to the organization

- ▶ Map the identified risks to internal controls
- ▶ Assess the effectiveness of the controls
- ▶ Compare to leading practices
- ▶ Perform sample testing
- ▶ Determine the level of residual risk and assign priority ratings to each risk identified

- ▶ Determine and document management's response to residual risk
 - ▶ Avoid
 - ▶ Transfer
 - ▶ Mitigate
 - ▶ Assume
- ▶ Determine plan for continuous monitoring of identified risks

Assemble the proper team

- Chose the right sponsor
- Ensure access to the entire organization
- Select team members with adequate technical skills
- Consider the independence/objectivity of the team members

Plan

Assess

Respond

Report

Management

Operations

HR

Consultants

Compliance

Accounting

Internal
Audit

IT

External
Audit

Understand organization risks

Understand the types of risks present:

Plan

Assess

Respond

Report

- **Inherent risk** – Present regardless of management's actions, based on the nature of the business.
- **Residual risk** – Remaining risk after management's actions, contingent upon what controls are in place

The ultimate goal of the Fraud Risk Assessment is to determine the residual risk present in the organization. However, during the planning stage, all risks should be considered.

Communicate goals

Plan

Assess

Respond

Report

- Management should set the tone of the assessment
- Employees should be encouraged to actively participate
- Information must be shared freely



Distribute questionnaires

Plan

Assess

Respond

Report

- Questionnaires allow access to large numbers of personnel, in an anonymous format

	Yes	No	Not Applicable
Do any employees have large personal debts or credit problems?			
Do any employees appear to be spending far more than they are earning?			
Do any employees gamble excessively?			
Do any employees use alcohol or drugs excessively?			
Do any employees resent their superiors?			
Do any employees have a close association with vendors or competitors?			
Do any employees have outside business interests that might conflict with their duties at the company?			
Is the company experiencing high employee turnover?			
Are employees required to take annual vacations?			

Hold focus groups

Plan

Assess

Respond

Report

- Focus groups allow individuals from different parts of the organization to discuss and explore fraud issues in an open, controlled environment
- Skilled facilitators are crucial to ensure that the discussions stay on track and explore all relevant risks
- During the session, anonymous survey devices can be used to poll the participants on their opinions of certain fraud risks

Interview key employees

Plan

Assess

Respond

Report

- Interviews allow in-depth discussion of fraud risk with employees most knowledgeable of risks and controls
- The interviewers should be non-confrontational and clearly state the purpose of the interview
- Employees can be encouraged to think of hypothetical situations, such as “If you were promoted, how could someone who took your place commit fraud against the organization?”

Understand risk impact

Plan

Assess

Respond

Report

- During the assessment phase, the team should make an effort to understand the potential impact to the organization posed by each risk

Simple example

Dollar impact of risk = \$10,000,000

Likelihood of occurrence = 20%

Potential impact = \$10,000,000 x 20% = \$2,000,000

- Also consider non-financial impacts of fraud risks:
 - Reputational
 - Legal
 - Regulatory

Assess effectiveness of controls

Plan

Assess

Respond

Report

- Each risk should be mapped to its corresponding controls
- For key risks, the controls can be tested, through sample testing
- The team will assess whether the controls seem to be functioning as intended

Simple example

Control – All employee expense reports must be approved by manager

Test – Select a sample of expense reports and look for evidence of approval

Result – If a significant percentage of the sample lacked approval, the control may not be functioning properly

Rank and prioritize risks – heat map

Plan

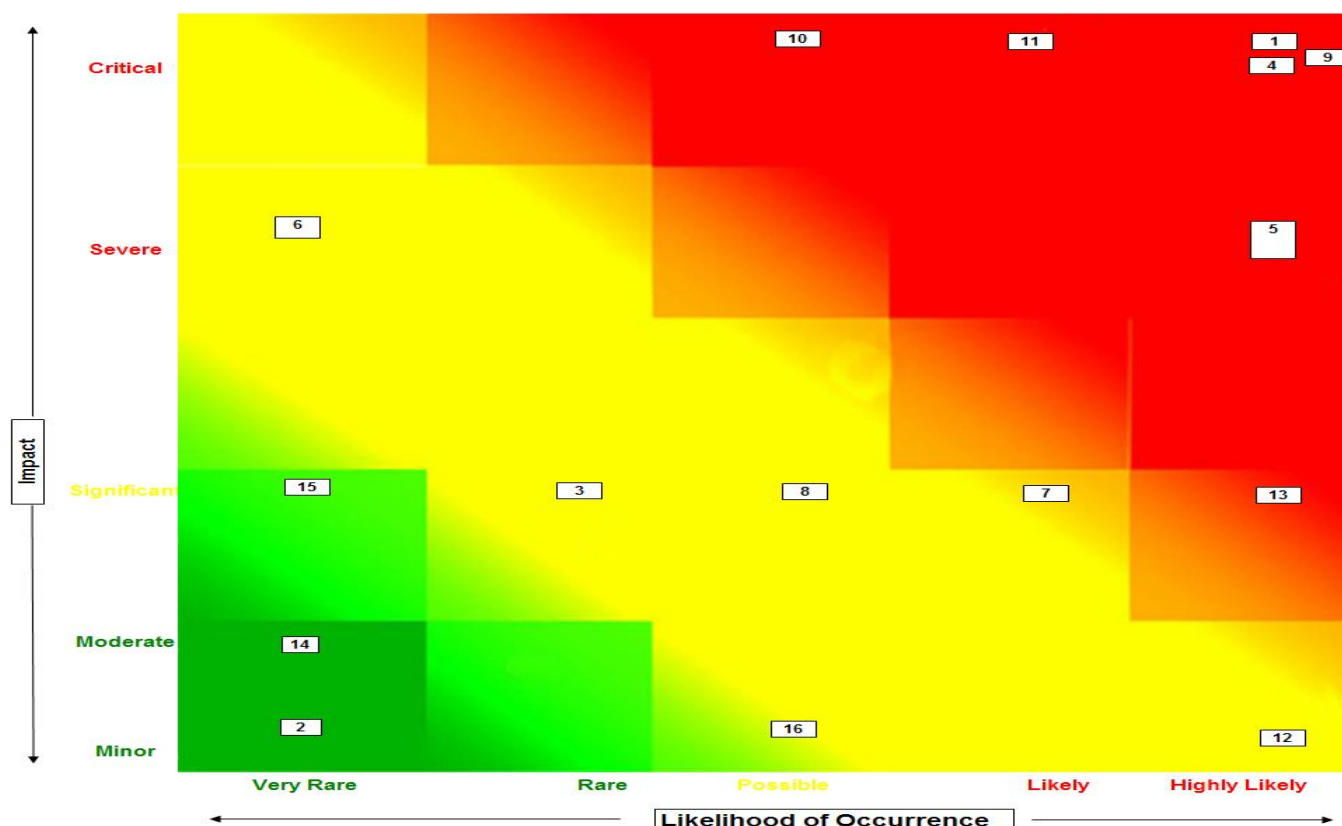
Assess

Respond

Report

- Risks should be tied to controls to understand and rank the residual risks

Fraud Risk Assessment - Overall Schemes



Legend		
Fraud Schemes	Impact	Likelihood
1 FCPA	Critical	Highly Likely
2 Bill and Hold Transactions	Minor	Very Rare
3 Trade Loading/Channel Stuffing	Significant	Rare
4 Commercial Bribery	Critical	Highly Likely
5 Fraudulent Workers Comp Claims	Severe	Highly Likely
6 Customer Side Agreements	Severe	Very Rare
7 Fraudulent Inventory Capitalization	Significant	Likely
8 Fraudulent Overstatement of Trade Receivables	Significant	Possible
9 Conflicts of Interest	Critical	Highly Likely
10 Vendor Fraud	Critical	Possible
11 Benefit Fraud	Critical	Likely
12 Expense Reimbursement Fraud	Minor	Highly Likely
13 Procurement Fraud	Significant	Highly Likely
14 Cash Skimming	Moderate	Very Rare
15 Theft of Inventory	Significant	Very Rare
16 Sales and Marketing Fraud	Minor	Possible

Determine Managements Response

Plan

Assess

Respond

Report

Management will decide on the organizational response to the residual risks identified

- **Avoid** – Management can avoid a risk by stopping the underlying activity all together
- **Transfer** – Management can transfer a risk by moving the potential impact elsewhere, such as by purchasing fraud insurance or asking a business partner to perform the underlying activity
- **Mitigate** – Management can mitigate a risk by adding additional controls which will reduce the residual risk to an acceptable level
- **Assume** – Management can assume a risk by determining that the currently present residual risk is already at an acceptable level when considered against the cost of additional controls, so no further action will be taken

Report Results

Plan

Assess

Respond

Report

- The report should be easy to understand and digest
- Format of the report is flexible, could be oral presentation or full written report
- All key information should be reported
- Management should sign-off on the report and the results communicated to the organization
- Periodically, key risks from the assessment should be revisited, with key controls continuously monitored

CASE STUDY

- *Case Study on Financial statement, contracts and procurement fraud Analysis:
Lessons learnt and way forward*



