

Detecting financial statement fraud

What every manager needs to know



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Given the current state of the economy and recent corporate scandals, fraud is still a top concern for corporate executives. In fact, the sweeping regulations of Sarbanes-Oxley, designed to help prevent and detect corporate fraud, have exposed fraudulent practices that previously may have gone undetected. Additionally, more corporate executives are paying fines and serving prison time than ever before. No industry is immune to fraudulent situations and the negative publicity that swirls around them.

The implications for management are clear: Every organization is vulnerable to fraud, and managers must know how to detect it – or at least when to suspect it.

Fraud: what it is and how it happens

Before examining the most common types of fraud and how to detect them, it's worth reviewing what fraud is, why it happens and how it manifests itself in corporations. According to the Association of Certified Fraud Examiners (ACFE), fraud is "deception or misrepresentation that an individual or entity makes knowing that the misrepresentation could result in some unauthorized benefit to the individual or to the entity or some other party." In other words, mistakes are not fraud.

Why does fraud happen? A useful model for this discussion is the "fraud triangle" described by the late Donald R. Cressey, a criminologist who studied embezzlers. Cressey said three factors are typically present when a fraud occurs: *rationalization*, *opportunity* and *pressure*. While discussion of rationalization may be best left to psychology textbooks, opportunity and pressure are directly tied to today's corporate environments and can be influenced significantly by management. Opportunity can arise from a lack of organizational controls and security; a company deficient in these areas is creating ample opportunity

for fraud to occur. Pressure can be created by the demands to meet earning targets and is often tied to compensation under management incentive plans.

Most important, this pressure can affect the "tone at the top," or the implicit messages that management sends to employees by virtue of emphasis, proportion and frequency. A tone that places a disproportionate emphasis on financial results or stock price may send the message that cutting corners is acceptable.

Management would be well-advised to examine both the opportunities and pressures that exist in their organizations.

Corporate fraud generally falls into one of three categories: *asset misappropriation*, *corruption* and *financial statement fraud*. The first, and by far the most common, category is asset misappropriation – essentially, stealing – which includes larceny (i.e., after the asset is recorded on the books) and skimming (i.e., before the asset is recorded on the books). According to the 2008 ACFE Report to the Nation on Occupational Fraud & Abuse, asset misappropriation accounted for 88.7% of reported incidents. Corruption came in a distant second at 27.4%. Corruption is a catch-all category that includes conflicts of interest, bribery and extortion. The least-frequent form of occupational fraud in the study was fraudulent financial statements (i.e., fudging the numbers), which accounted for 10.3% of incidents.¹

¹ Note: Percentages sum to greater than 100% because some cases represented more than one fraud category.

Misstatements: the toll in dollars and damage

While most infrequent, it is this last category, financial statement fraud, that should receive the most attention from public company managers because it is by far the most expensive, in terms of both absolute dollars and long-term damage. According to the same ACFE report, the median loss of a fraudulent statement incident was \$2 million, compared with \$375,000 and \$150,000 for corruption and asset misappropriation, respectively. When taking into account the loss of investor confidence, as well as reputational damage and potential fines and criminal actions, it is clear why financial misstatements should be every manager's worst fraud-related nightmare.

Fraud in emerging markets

Moreover, Ernst & Young's most recent annual Global Fraud Survey² suggests that companies doing business in emerging markets – and, given the global nature of the oil patch, there are few companies that don't – may be underestimating the risk of financial statement fraud. While respondents to the survey considered bribery and corruption as the greatest fraud risk in emerging markets, our experience demonstrates that lack of management oversight and controls can cause significant financial statement errors in business units at remote locations.

Schemes, red flags and questions to ask

While the opportunity for misstatement exists on each line of every financial statement, a handful of culprits account for the majority of cases. It is incumbent upon managers to be familiar with these culprits and know which red flags might indicate their presence. Of course, red flags are not sure-fire signs of fraud. Rather, they are signs that questions need to be asked and that reasonable answers need to be found.

² *Corruption or compliance – weighing the costs*, Ernst & Young's 10th Annual Global Fraud Survey, 2008.

To help managers know when to raise eyebrows and start asking questions, the Association of Certified Fraud Examiners has developed a list of common accounting fraud schemes and associated red flags. More details are available in the ACFE's publication *Fraud and the CPA: Understanding Why Employees Commit Fraud*.³ The ACFE's schemes and red flags are listed below, along with a series of questions that managers should ask when the red flags appear.

Overstating revenues

Starting literally at the top of an income statement is always a good idea. Overstating or improperly recognizing revenues is a common form of financial statement fraud.

Schemes

- ▶ Recording gross, rather than net, revenue
- ▶ Recording revenues of other companies when acting as a "middleman"
- ▶ Recording sales that never took place
- ▶ Recording future sales in the current period
- ▶ Recording sales of products that are out on consignment

Red flags

- ▶ Increased revenues without a corresponding increase in cash flow, especially over time
- ▶ Significant, unusual or highly complex transactions, particularly those that are closed near the end of a financial reporting period
- ▶ Unusual growth in the number of days' sales in receivables
- ▶ Strong revenue growth when peer companies are experiencing weak sales

³ Also see *Managing the Business Risk of Fraud: A Practical Guide*, Association of Certified Fraud Examiners, the Association of Certified Public Accountants, the Institute of Internal Auditors, July 2008.





Questions to ask

- ▶ Why did revenues increase sharply during the end of the period compared with prior-year and current-year results and the budget forecast?
- ▶ How does revenue growth compare with that of peers during the same period? If substantially higher, does the explanation make sense?
- ▶ Did receivables increase due to a particular customer? If so, should a reserve be established?

Understating expenses

Another common number-fudging technique is understating expenses, which leads to increased operating income and net income.

Schemes

- ▶ Reporting cost of sales as a nonoperating expense so it does not negatively affect gross margin
- ▶ Capitalizing operating expenses, recording them as assets on the balance sheet instead of as expenses on the income statement
- ▶ Not recording some expenses at all, or not recording expenses in the proper period

Red flags

- ▶ Unusual increases in income or income in excess of industry peers
- ▶ Significant unexplained increases in fixed assets
- ▶ Recurring negative cash flows from operations while reporting earnings and earnings growth
- ▶ Allowances for sales returns, warranty claims, etc., that are shrinking in percentage terms or are otherwise out of line with those of industry peers

Questions to ask

- ▶ Why did gross margin (by location, product and geographic area) increase during year-end or period-end compared with the prior-year and current-year budget forecast? Does the explanation make sense?

- ▶ How does the company compare to competitors in terms of net income during the same time period?
- ▶ What were the major additions to fixed assets during the year? Is the treatment of recording assets consistent with that of prior years?

Improper asset valuations

Highly publicized asset write-downs following the disclosure of faulty reserve reports should make all company managers pay special attention to how they report their most important hard assets.

Schemes

- ▶ Manipulating reserves
- ▶ Changing useful lives of assets
- ▶ Failing to take a write-down when needed
- ▶ Manipulating estimates of fair market value

Red flags

- ▶ Recurring negative cash flows from operations while reporting earnings and earnings growth
- ▶ Significant declines in customer demand and increasing business failures in either the industry or the overall economy
- ▶ Assets, liabilities, revenues or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate

Questions to ask

- ▶ How is the overall economy affecting customer demand and business? Declines in both could be a signal that there might be an asset impairment issue involving inventory or allowance reserves.
- ▶ For areas where there are significant estimates, what is the method used to determine the estimate?
- ▶ Is this method consistent with that of prior periods?
- ▶ What supporting documentation is available to support the calculation?

Other common areas for financial statement fraud

The following are also schemes used frequently to “cook the books” and make results look better than they really are.

Schemes

- ▶ Smoothing of earnings: Often referred to as using “cookie jar reserves,” this involves overestimating liabilities during “good” periods and storing away funds for future use against declining revenues
- ▶ Disclosing information improperly, especially concerning related-party transactions and loans to management
- ▶ Executing highly complex transactions, particularly those dealing with structured finance, special-purpose entities and off-balance sheet structures, and unusual counterparties

Red flags

- ▶ Domineering management
- ▶ Decision to “fix” accounting in the next period
- ▶ No apparent business purpose
- ▶ “Reality” of transaction differs from accounting or tax result
- ▶ Significant related-party transactions
- ▶ Counterparts that lack economic substance
- ▶ Multiple memos rationalizing an aggressive accounting treatment

Questions to ask

- ▶ Is there an overly aggressive push by management to meet previously disclosed revenues or earnings targets?
- ▶ Can management explain the business purpose for entities that are outside the consolidated financial statements?
- ▶ Were there significant adjustments made at the end of the period?
- ▶ Has there been an unusual focus on achieving a certain accounting treatment?
- ▶ Does the business purpose make sense?

- ▶ Does the preferred accounting treatment allow the company to meet certain targets?
- ▶ Has there been a change in the method of calculating the reserve estimates for any item from that used in the prior quarter or prior years? If so, why?

When fraud is suspected

Ideally, questions that are prompted by red flags will result in answers that make perfect sense. But when they don't, it's time to consider two actions: notifying the audit committee and calling in the forensic accountants.

Forensic accountants are the crime scene investigators of the financial world. They have extensive experience examining the DNA of financial statements; sifting through email records, documents and data entries; and conducting extensive interviews to uncover and explain the most complex financial statement fraud. They are also trained to uncover and preserve evidence to make it admissible in court should the need arise.

When engaging forensic accountants, it is important to consider three qualifications. The first is forensic accounting experience. The abundance of corporate scandals in the last few years has created a forensic accounting boom, and many accountants with backgrounds other than forensics have established themselves as forensic accountants. It is important for companies seeking the help of forensic accountants to find out how long they have been practicing forensic accounting and whether the personnel who will be examining potential red flags have appropriate credentials (e.g., are they CPAs or CFEs [Certified Fraud Examiners]?).

The second qualification is industry experience. A forensic accountant fluent in financial statements for a manufacturing or retail company might be lost trying to navigate the engineering and geophysical components of an investigation into the possible overstatement of oil and gas reserves.

The third qualification is the breadth of services offered by the accounting firm and its global reach. While a forensic accounting specialty shop might be able to conduct a solid, professional investigation of a small matter, it may not be able to address the issues that led to the fraud in the first place – issues like inadequate financial controls, insufficient or nonexistent processes or weak information technology infrastructure and security. A full-service firm, on the other hand, can move from a fraud investigation to the fraud prevention initiative that should follow. For energy companies operating internationally, use of a firm that can operate seamlessly on a global basis is critical to make certain that all elements of activity can be included in the investigation.

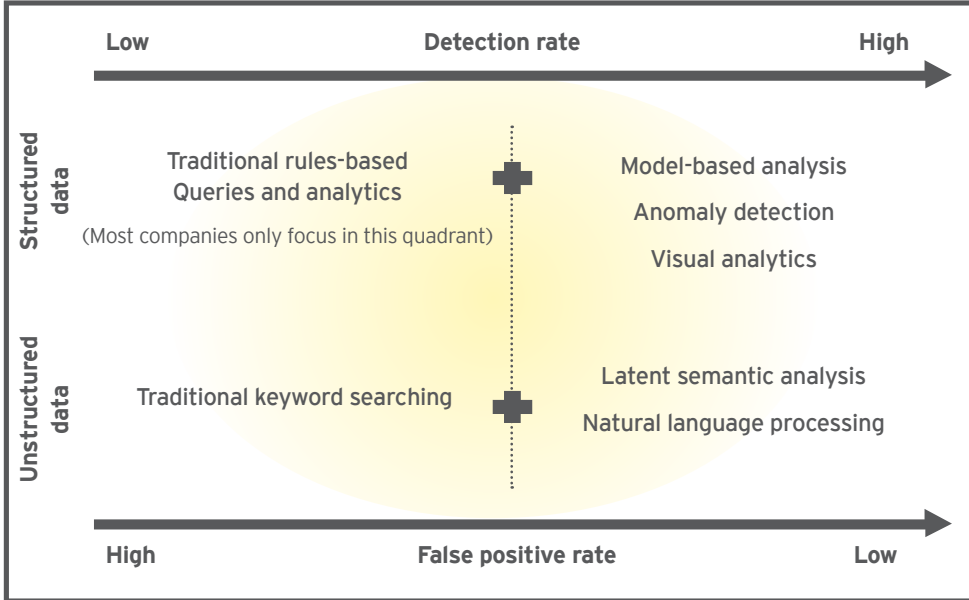
Advances in fraud-detection technology

According to the ACFE's 2008 *Report to the Nation* previously referenced, 66% of occupational fraud was detected by tips or by accident, while internal audit and internal controls monitoring only accounted for 42%.⁴ Given the current advancements in technology and the increased regulatory climate, it seems counterintuitive that the leading source of fraud detection is still by tip or by accident.

Today, 80% of enterprise data is unstructured in nature (text-based sources including documents, presentations, email, etc.), yet most of today's automated, anti-fraud detection tools and audit techniques focus on the other 20%, which is structured data (numbers-based sources including transactional databases, general ledgers, etc.). It is the text-based information, or unstructured data, that often can provide valuable insight into the who, what, when and why of business risks or fraud. When managers do not consider both structured and unstructured data to proactively detect

⁴ According to the survey, tips were the most frequently reported source of initial detection for occupational fraud (46%), followed by accident (20%); 19% of occupational fraud was uncovered by internal audit and 23% was uncovered by internal controls.

Fraud detection maturity model



fraud, it is no wonder that most fraud is uncovered by tip or by accident rather than by proactively monitoring and detecting fraudulent activities through the use of internal controls.

The challenge of unstructured data

When considering unstructured data such as documents, email or presentations, most managers rely on page-by-page reading of selected documents to understand the meaning or purpose of a key event or risk. Given the volume of such data and the length of time needed to read just one page of text, this type of review can be daunting. Even when technology such as keyword searching is applied to unstructured data, it is still a page-by-page process. Furthermore, keyword searches can be limited in terms of precision (too many false positives) and accuracy (finding relevant documents). Because of these challenges, and their respective costs to review, keyword searching within unstructured data has been a task typically reserved for government agencies, and attorneys and forensic accountants when an investigation is already underway.

Antifraud technology

There is a better approach to detecting fraud. To find meaning within large corpuses of data, business documents can, in fact, be analyzed – not necessarily read – by managers in order to understand the who, what, when and why of key business risks or events.

Using software technologies such as latent semantic analysis and natural language processing permits large amounts of text to be efficiently synthesized and summarized to report on:

- ▶ Who is talking to whom?
- ▶ About what? (key noun or noun phrases)
- ▶ Over which time period?
- ▶ How does the author/writer/person feel? (emotional sentiment)

Combining structured and unstructured data

As the graphic above demonstrates, when unstructured and structured data are integrated, text-based comments in journal entries can be analyzed and

mapped to clusters of specific transactions. Email communications can be mapped to specific entries made in the general ledger and charted over time to identify key trends or spikes near the year-end cutoff. Communications between the executive management and the stock options administrator in the HR department can quickly be identified to spot instructions to back-date stock options, which are then tied to the stock granting and management database. As anti-fraud programs and supporting technologies mature within today's organizations, managers have the potential to move toward greater detection rates and fewer false positives. Perhaps this will give managers the upper hand in fraud detection rather than having to rely on anonymous tips or accidental discoveries to uncover fraud.

Trust your judgment

Although red flags almost always accompany fraud, many financial misstatements are either reported too late to prevent major damage or are not reported at all. Sometimes, late or nonreporting occurs because managers are not paying close attention, but sometimes it is because they are too afraid or not knowledgeable enough about fraudulent behavior to act. This can be the result of not wanting to know the truth. But often, it is a result of not trusting one's judgment or intelligence. Managers may automatically think there is a simple explanation for a red flag and that asking about it reveals their ignorance or lack of financial sophistication. Every company's accounting should be understood by its management, and if it is not, it may be due to fraud rather than a manager's lack of sophistication.

Managers should always trust their judgment and intelligence when considering accounting red flags. Sometimes these red flags will have legitimate explanations, but other times they may be only the tip of an iceberg of financial statement fraud.

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