On the Lookout for Financial Statement Fraud: The Power of Speak Up and Other Strategies to Detect Corporate Misconduct

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The Association of Certified Fraud Examiners (ACFE) has released their latest "Occupational Fraud 2024: A Report to the Nations[1]". According to the global study, occupational fraud is very likely the largest and most costly of financial crimes. The estimated related annual cost amounts to trillions of dollars.

The ACFE categorizes occupational fraud in three primary categories: asset misappropriation, corruption and financial statement fraud. The most prevalent category of occupational fraud is asset misappropriation, which occurred in 89% of the cases in the study, with a median loss of $120,000. Asset misappropriation involves an employee stealing or misusing organizational resources. Corruption was present in nearly half of the cases in the study, namely 48%, with a median loss of $200,000.

It is impressive that the financial statement fraud, the least common category with 5% of the cases in the study, caused the greatest median loss, of $766,000 per case.

In this article, we discuss types of financial statement fraud, who is usually involved in it and what can be done to prevent it from happening.

Accounting is not an exact science

According to the ACFE report, financial statement fraud is "a scheme in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports (e.g., recording fictitious revenues, understating reported expenses, or artificially inflating reported assets)". In other words, financial statement fraud involves deliberately overstating or understating financial data to mislead stakeholders about a company's financial health. It is important to note that also the omission of relevant facts (e.g., improper disclosures) can form part of financial statement fraud.

But why is financial statement fraud leading to such significant losses and what can a company do about it?

Financial statement fraud leads to substantial losses because it is often perpetrated by those individuals who have the greatest influence over a company's financial figures, valuations, estimations and accounting principles. These losses tend to accumulate over a long period of time, as the fraud usually goes undetected for several years.

Critically, the individuals involved hold the levers of power, possessing extensive latitude to manipulate financial data. They also sometimes exploit this flexibility to alter outcomes to their advantage, impacting stakeholders and concealing the true financial condition of the organization.

In this context, the most common instances of financial data manipulation are the following:

- **Revenue recognition:** Manipulating the timing and recognition of revenue is a common method. For example, to inflate sales figures, individuals may record revenue before goods are delivered or services rendered to. This approach is especially tempting at quarter or year-end to meet certain Key Performance Indicators (KPIs).
- **Asset valuation:** Overstating or understating the value of assets, such as inventory or real estate, can significantly alter a company's financial health on paper. Many factors can be taken into account to over- or understate inventory values, such as changes in raw material costs, changes of production cost or exchange rates.
- **Provisioning:** Inadequate provisioning for expenses, liabilities or losses can overstate profits. Conversely, excessive provisions can be used to smooth out earnings over time or prepare for future profit boosts when these provisions are reversed. Expert opinions requested by companies might be steered by the way the companies provide documentation on the underlying assumptions.
- **Reserve manipulation:** Altering reserves to manage earnings is another area where significant discretion can be exploited.
- **Capitalizing vs. expensing:** Deciding whether to immediately expense costs or capitalize them, thereby spreading their impact over a longer period, can affect short-term profitability.
    - Capital Expenditure (Capex) involves the funding of assets like equipment or buildings that will provide benefits over a longer period. These costs are capitalized, meaning they are added to the balance sheet and depreciated over the economic useful life of the asset, thereby spreading out their financial impact. In addition to the decision to capitalize costs, the decision on the economic useful life of an asset also greatly influences long-term numbers.
    - Operating Expenditure (Opex) includes costs that are incurred in the day-to-day operations of a business and are expensed immediately in the income statement, impacting on the current period's profitability.
- **Complex transactions:** Using complicated financial instruments or transactions that are difficult to understand, such as off-balance sheet financing, can hide the true nature of financial data. Round-tripping is a sort of complex transaction where a company sells an asset to another party, often a related party, and simultaneously agrees to buy back the same or a similar asset at a similar price. The primary purpose of these transactions is to inflate revenue and earnings figures without producing any actual economic benefit or change in ownership.
- **Related-party transactions:** Transactions with entities related to company insiders can be used to transfer profits or losses in ways that benefit those insiders, at the expense of the company and its shareholders.

Trust is the currency for financial statements

Even the slightest suspicion of financial statement fraud, up to a serious breach of ethical accounting practices, can have devastating effects on a company’s reputation, its stock value, investor and stakeholder trust, as well as public perception. So, what can companies do to prevent financial statement fraud and safeguard their reputations?

Common preventative measures include strengthened corporate governance and culture, strong internal controls, regular audits, training and awareness as well as fraud risk assessments. Technology should be leveraged to help detect anomalies, outliers and patterns. Most companies have these measures in place, to some extent, which is both important and relevant. Why then is financial statement fraud still so common in today’s corporate world?

The employees who usually commit financial statement fraud belong to the inner circle of a company who have the power and resources to conceal their schemes. According to the ACFE report, the most common methods to conceal crimes were creating (41%) or altering (37%) fraudulent physical documents, followed by creating (31%) or altering (28%) electronic documents or files. In addition, 23% of fraudsters conceal their schemes by destroying or withholding physical documents, whereas 19% create fraudulent transactions in the accounting system and 19% delete or withhold electronic documents or files. 16% alter transactions in the system.

Those percentages suggest there are plenty of signals within the financial statements that would alert others to the fraud. In reality, whistleblower reports (e.g. tips) are the most common way frauds come to light (43% of the cases), with 52% of those tips coming from employees, 21% from customers and 11% from vendors.

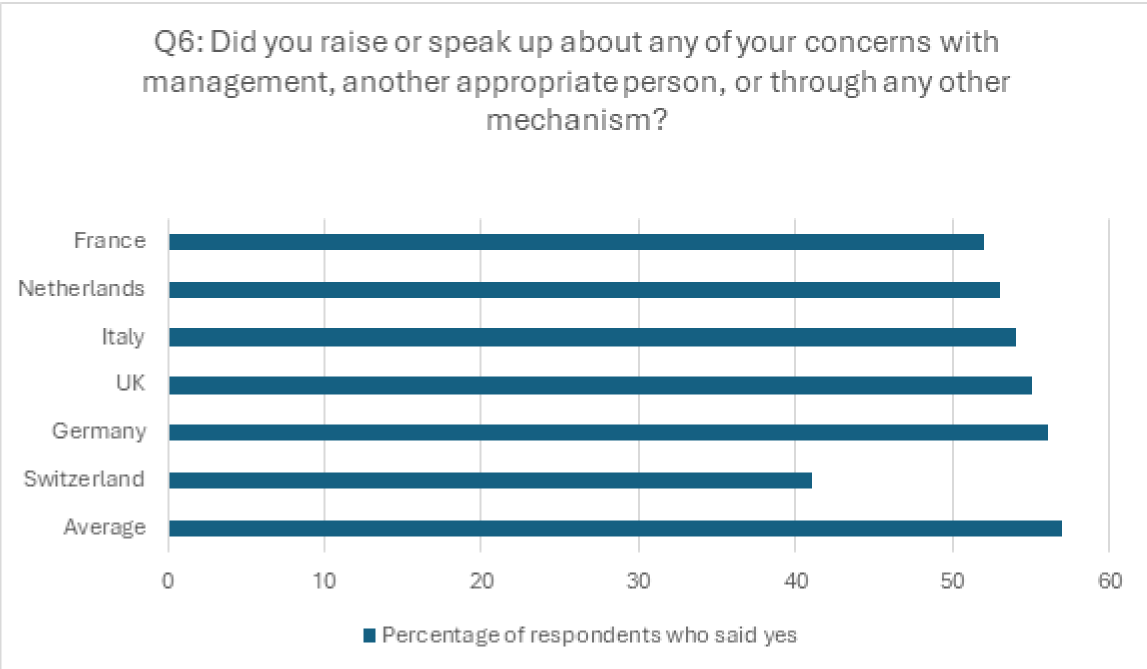
Here are some of the preventive measures to avoid falling victim to financial statement fraud:

- **Integrity first:** Organizations should put strong emphasis on and consideration around the integrity of the company’s CFO, head of accounting, CEO, as well as accounting managers and controllers. These positions are particularly critical because they influence how revenue, expenses and profits are reported, and their behavior also influences the behavior of the other employees.

- **Get the incentives right *and* aligned:** KPIs can be a two-edged sword. On one hand, they translate the company's goals into measurable figures. On the other hand, especially if executive compensation is predominantly based on KPIs, they can become prime targets for manipulation, as the individuals influencing these metrics are the same ones who benefit from them. In addition, conflicting or overly aggressive goals can be a trigger for fraud and misconduct. Alignment between compliance KPIs and other corporate KPIs can prevent employees from resorting to misconduct to meet requirements.
- **Let employees speak up:** As discussed above, whistleblower reports are the most common way through which frauds are discovered. A whistleblowing hotline promotes transparency and accountability by providing a secure channel for employees to report unethical behavior or violations without fear of reprisal. Without a trusted whistleblower hotline, companies face the risk of fraud and misconduct going undetected for a longer time, leading to higher losses.

"Speak up" culture varies; employees in Switzerland are more reluctant

Cultural attitudes toward whistleblowing vary considerably. According to a survey with 10,000 adult workers in 13 countries[2], only 41% of employees in Switzerland said they raised concerns with management or other appropriate person after becoming aware of misconduct, the lowest level among countries in the survey, and well below the average of 57%. Across Europe, 56% in Germany, 55% in the U.K., 54% in Italy, 53% in the Netherlands and 52% in France said they speak up about misconduct.



It is worth noting that currently Switzerland has no law protecting whistleblowers from dismissal. The latest attempt to grant whistleblowers extra protection was voted down by the National Council last February[3]. The decision comes despite calls from the OECD's Working Group on Bribery, which has urged Switzerland[4] to adopt legislative reforms to enhance whistleblower protection in the private sector.

The low percentages seen in the survey also indicate there is a huge potential for companies in Switzerland to increase the number of tips, which can in turn lead to fewer losses from financial statement fraud and other misconduct. Therefore, companies are well advised to create a culture in which people feel comfortable speaking up.

Conclusion

In summary, although financial statement fraud reflected only 5% of the cases in the ACFE study, it caused the greatest median losses per case. Suspected financial statement fraud can have a devastating impact on the trust which is placed in a company and often leads to major reputation, and/or financial, crises.

As with any economic crime, prevention and early detection is key. While many companies implement measures like internal controls, audits and fraud risk assessments, the most effective detection method has been whistleblower reports. Additionally, an effective prevention method is to hire “fit and proper” CFOs, CEOs and heads of accounting.

Financial statement fraud poses significant risks to a company's reputation and financial stability, often perpetrated by insiders with access to critical financial figures. Encouraging a culture of integrity, a proper tone from the top and allowing safe channels for employees to report potential fraud or misconduct are crucial steps in preventing or minimizing the risks and losses from this type of fraud.

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[1] Occupational Fraud 2024: A Report to the Nations

[2] Ethics at Work: 2021 international survey of employees

[3] National Council of Switzerland voted against a new Whistleblower Bill

[4] OECD Working Group on Bribery states that Switzerland should urgently take concrete steps

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