How to Spot Financial Statement Fraud

It helps to know the common schemes and red flags to look for

By Hubert Klein / EisnerAmper LLP

Hubert Klein, *CPA/ABV/CFF, CVA, CFE, is a partner in the financial advisory services group of EisnerAmper LLP. He specializes in forensic accounting and fraud investigations, complex damages analysis and litigation support services. He can be reached at hubert.klein@eisneramper.com.*

Reliable financial reporting is the backbone of the global equity and finance markets. It helps to ensure that companies and organizations comply with relevant standards and regulations, in addition to providing investors and third parties with information on the current financial health of a company.

Financial statements generally include four sections: the balance sheet, income statement, cash flow statement and management's notes and disclosures. The balance sheet captures a snapshot of the assets, liabilities and equity positions of an organization. The income and cash flow statements are generated by the operations side. Management's notes and disclosure reports in narrative form on accounting principles and required financial disclosures that are considered useful to the readers of the financial statements.

Together, the financial statements and related notes are used by management, investors, lenders and regulators to make decisions. In order to ensure the integrity of financial statements, and because they are important in making management and investment decisions, there are a lot of rules, regulations and standards that govern how they are prepared and what they must include.

However, there are times when people with nefarious intentions purposely manipulate and distort financial statements in order to show a different picture. This is commonly referred to as financial statement fraud – the deliberate misrepresentation, misstatement or omission of financial statement data for the purpose of misleading the reader to create a false impression of an organization's financial strength.

Financial statement fraud is perpetrated on both public and private businesses. Generally, those who do so seek to increase investor interest, obtain bank financing, justify bonuses or meet the expectations of shareholders or the marketplace. Many times upper management is at the center of the fraud because they are responsible for the content and preparation of financial statements. Often their job performance is judged based on the reported financial results. When results are manipulated, many people are negatively impacted – employees, investors and third parties.

A recent survey found that financial statement fraud results in the largest median loss of all fraud losses – nearly $1 million.

Financial statement fraud can be very costly. However, its methods are complex and often the related schemes are not understood by the average person or investor. Unless a famous individual or company is involved, it often goes unnoticed. According to the Association of Certified Fraud Examiners (ACFE) 2016 Global Fraud Survey, financial statement fraud results in the largest median annual loss out of all other types of fraud losses. According to the survey, the median loss incurred by organizations was $975,000.

The most common financial statement fraud schemes include:

- Revenue overstatement – recording of revenues in improper periods to reach a desired earning amount.
- Overstatement of assets – assets are written up to current market value, or impairment of intangible asset values isn't properly recognized.
- Concealed liabilities and expenses – purposely omitting or understating them so that the financials appear more profitable.
- Improper or misleading disclosures – not providing all the necessary information required in order to mislead the financial statement user.

To safeguard your company from falling victim to financial statement fraud, be aware of red flags such as these:

- Aggressive or unrealistic profitability expectations created by management.
- Ineffective communication and support of the organization's ethical values by management.
- Recurring negative cash flows from operations while the company reports earnings and growth.
- Rapid growth or unusual profitability, especially compared to those of other companies in the same industry.
- Significant, unusual or highly complex transactions, especially close to the end of an earning period.

It is important to note that those who are willing to commit financial statement fraud do not discriminate. It can happen in companies large and small, and across all industries and geographic locations. Therefore, it is vital for an organization to have fraud prevention and detection policies and procedures in place. Implementing strong and effective internal controls can help prevent these red flag situations.

Studies show that having a strong control environment along with a management culture of intolerance for circumventing these controls is paramount to minimizing the risks. Proper planning and controls can help avoid the devastating losses and embarrassment that come when organizations are defrauded.