

Financial fraud: Does an economic downturn mean an uptick?

As economic conditions soften around the globe, fraud risks for businesses appear to be on the rise. A slowing economy may increase pressure on companies to meet — and often exceed — short-term performance goals (sometimes at the detriment to the organization in the long-term) or to demonstrate that shareholder value has improved due to management's leadership. In some instances, organizations may expect results that can be achieved only in a thriving economy. It is this mindset in slower economic times that can contribute to increased fraudulent activity.

Historical data supports this premise. As noted in a May, 2008 research study (“Research Advisory Board Study”)¹ of a sample of the Securities and Exchange Commission’s (“SEC”) Accounting and Auditing Enforcement Releases (“AAER”) filed from 1982 to 2005, most financial statement manipulations occurred in 1999 and 2000 — an economic slowdown fueled, in part, by the burst of the dot com bubble.

Furthermore, the United Kingdom’s Financial Services Authority, in its 2008 Financial Risk Outlook, warned that increased financial pressures could distract companies from their usual risk-management processes. If companies divert their attention from risk management issues, it may lead to opportunities for management and employees to commit fraud or break laws.

In this point of view, we discuss the potential impact an economic downturn or other adverse financial circumstances may have on fraudulent activity — and how to help prevent potential problems within your organization. Specifically, we will discuss:

- Three common factors driving fraudulent activity
- Common types of financial statement fraud
- Leading practices for controlling fraud risks
- Conducting investigations in economic downturns

During a July, 2008 Deloitte² Dbrief on financial fraud in an economic downturn, we asked more than 1,500 participants a series of questions. Throughout this point of view, we will highlight some of the questions and corresponding responses. For example, when participants were asked to “describe the potential impact of an economic downturn on fraud control effectiveness in their organizations,” 80% of respondents replied that it would have a significant or potentially significant impact on their organizations.

¹ Predicting Material Accounting Manipulations sponsored by the Research Advisory Board and conducted by Patricia M. Dechow (The Haas School of Business, University of California Berkeley), Weili Ge (Michael G. Foster School of Business, University of Washington), Chad R. Larson (The Stephen Ross School of Business, University of Michigan), and Richard G. Sloan (Barclays Global Investors).

² As used in this document, “Deloitte” means Deloitte Financial Advisory Services LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Three common factors driving fraudulent activity.

Fraud is committed primarily because of three factors: financial pressure, opportunity, and rationalization (also known as the Fraud Triangle). While these factors are present in a strong economy, they can be exacerbated during an economic downturn.

A closer look at all three elements of the Fraud Triangle reveals several factors, including:

Financial pressure. During an economic downturn, business units within organizations may face increased pressures to meet or exceed financial targets. With increased pressures, the risk for fraudulent activity — perpetrated by employees and management — increases as well. In fact, in Oversight Systems' 2007 Report on Corporate Fraud, 81% of the study participants stated that fraud occurs when employees and managers are faced with pressure to do "whatever it takes" to meet financial goals.

To exacerbate circumstances, as economic conditions decline, capital markets tend to grow increasingly sensitive to missed earnings or perceived "bad news." Therefore, to disguise deteriorating financial conditions, management may be more aggressive in its accounting practices and applications — particularly in areas involving management judgment.

Below, we discuss possible increased pressures employees and management may experience during economic slowdowns.

- **Employees:** The current economic environment, coupled with the mortgage crisis and rising gas and food prices, place tremendous stress on personal finances. With corporate profits declining, real wages for American workers have been growing slowly — less than 1.6% per year on average³. As a result, organizations may see an increase in asset misappropriation schemes, including skimming, check tampering, and expense reimbursement.
- **Management:** Management is often under pressure to meet short-term performance goals, such as earnings expectations, revenue forecasts, or financial ratios tied to debt covenants. In addition, management is often compensated with stock options or other equity instruments intended to align management and shareholder interests. With management's own performance and compensation tied to operating or financial goals, management may drive its employees to achieve overly optimistic results — particularly in an economic slowdown.

Opportunity. The perception of increased opportunity may stem from the impact that corporate stabilization strategies, such as downsizing and prioritization of revenue generating activities, may have on an organization's risk environment. Typically, as companies prioritize revenue generating activities (along with reducing expenses) over risk management issues, effective implementation of internal controls or fraud control policies may be neglected.

As organizations downsize, there may not be enough available employees for proper segregation of duties or to perform basic tasks — such as account reconciliations. If so, breakdowns in an organization's system of internal controls are more likely to occur. In fact, fewer employees may lead to individuals assuming roles or responsibilities that are incompatible or inconsistent with their job function or to a decline in the timeliness and accuracy of monitoring and reporting due to increased workloads and inexperience.

Rationalization. An increase in perceived opportunity coupled with increased pressures to perform, may make rationalizing fraudulent activity easier. Oftentimes, the greater the pressure, the easier it is to rationalize inappropriate activity.

On an individual basis, a lack of real growth in wages may increase pressure to meet personal financial obligations. As companies downsize, remaining employees may experience diminished morale, feel a decline in ethical concerns over financial reporting, or may even explore ways to defraud the company prior to being let go. If employees suspect that they may be let go, they may rationalize: What do I have to lose?

From management's viewpoint, as economic conditions soften, an organization may be challenged to maintain (or improve) its financial and operating performance. In fact, according to a July, 2007 press release from the University of California's Haas School of Business, a recent analysis of SEC AAERs observed that earnings manipulating companies appeared to have strong financial performance leading up to the manipulations. As corporate revenues decline, management may rationalize fraudulent activity believing it is serving the best interest of the company, its employees, and its shareholders.

³ Monthly Labor Review: Industry Output and Employment Projections to 2012 (February 2008)



Common types of financial statement fraud

Challenging economic conditions do not diminish the urgency to meet financial results; rather, they increase the demands to perform even more. Further, during economic downturns, there is often an increased scrutiny of expenses and costs.

Below, we outline several examples of how companies may manipulate its financial statements:

Revenue recognition. Revenue recognition schemes are by far the most prevalent — occurring in 53% of sample companies according to the Research Advisory Board Study. This finding is consistent with other studies, including a June, 2007 study conducted by the Deloitte Forensic Center⁴ — Ten Things About Financial Statement Fraud, and enforces the need to focus on revenue accounts when developing fraud risk assessments and internal controls. As pressures increase and corporate revenues decline, management may seek creative means to artificially inflate revenue, such as bill and hold, channel stuffing, premature revenue recognition, or other such schemes. A few common ways to manipulate revenue include:

- **Fictitious sales.** The recording of fictitious revenue tends to be more malicious than other types of earnings management because it involves false, unsubstantiated, or manipulated documentation. In this scenario, employees may submit evidence of a sale based on false documentation from an existing or nonexistent customer. A few other common methods of creating fictitious revenue include side agreements, contra agreements (sale that offsets a purchase transaction), and conditional sales.
- **Premature revenue recognition.** A customer and/or agreement exist; however, revenue is recognized in a manner which is not consistent with the revenue recognition criteria as specified by U.S. Generally Accepted Accounting Principles. Improperly recognizing sales — before shipment of the goods or delivery of services — is an easy way to artificially inflate revenue at quarterly cutoffs.
- **Channel stuffing or front loading.** When pressured to meet internal or external sales forecasts, employees may “stuff” more product through the channel — or into the marketplace — than can be reasonably absorbed. As an incentive for customers to purchase the product, special terms may be granted, including extended payment terms or other side agreements, allowing customers to return the product at a later date.
- **Contingencies.** Commonly seen in financing or clauses relating to delivery or installation, revenue is recognized before key parts of a transaction have been resolved or conditions in the agreement have been met. Until those additional steps have been executed or resolved, revenue should not be recognized.

Inventory and cost of goods sold (COGS). Inventory and COGS are also commonly manipulated accounts — 24% of sample companies according to the Research Advisory Board Study. A few common methods management may employ to manipulate inventory or COGS include understatement of reserves, overvaluation of inventory, and failure to recognize obsolescence or slow-moving goods.

Improper disclosures. Improper, incomplete, or omitted disclosures in financial statements attempt to mislead investors by representing a better financial position than may actually exist. For instance, companies may delay disclosing relevant or material information with the intention of turning around or restructuring a troubled unit or segment. The issue of improper disclosures is under increased scrutiny. In a February, 2008 article appearing in the Washington Post, Susan G. Markel, the Chief Accountant of the SEC’s enforcement division, addressed her agency’s concerns by saying “Are people trying to delay the bad news?...That’s something that we are looking for...not just in subprime but in other contexts, too.”⁵

Manipulation of reserves or expenses. The manipulation of expenses and reserves is often one of the top choices for those seeking to fraudulently improve financial statements. For instance, bad debt reserves may be unreasonably reduced to inflate earnings. Also, expense capitalization policies may be revised, overlooked, or manipulated in an effort to capitalize expenses (rather than properly expensing through the income statement) to present a better financial position than may actually exist.

Foreign Corrupt Practices Act (“FCPA”) violations. As the U.S. economy softens, many organizations may try to improve declining U.S. sales by expanding into international markets through acquisitions or joint ventures. However, such international growth can bring additional financial and operational risks — particularly as compared to traditional U.S. markets. For example, when organizations grow through acquisition, but fail to align information technology or financial systems, the company’s existing internal controls over financial reporting may become weakened or (possibly) ineffective.

Additionally, transparency is often lacking in emerging markets, and the payment of bribes to obtain or retain business is commonplace. In recent years, enforcement of the FCPA has increased dramatically as the Department of Justice (“DOJ”) and SEC have increased investigation efforts. FCPA violations may expose companies to severe financial penalties, including fines and disgorgement of profits, costly investigation procedures, external monitors and reputational damage. Organizations that perform pre-acquisition integrity due diligence — investigating the company, its officers, agents, and related business partners — may be in a better position to address FCPA risks.

When asked what they believe “will be the trend for the number of accounting frauds uncovered in the next two years,” a majority of the over 1400 respondents (63%) in the recent Dbriefs webcast said it will increase.

⁴ The Deloitte Forensic Center (www.deloitte.com/us/forensiccenter) is a think tank aimed at exploring new approaches for mitigating the costs, risks, and effects of fraud, corruption, and other issues facing the global business community.

⁵ “A Labyrinthine Path to Justice”, *The Washington Post*, February 14, 2008

Leading practices for controlling fraud risks

Despite the threat of financial fraud in a sluggish economy, there are actions you can take today to manage your organization's exposure. In July, 2008, new guidance was published by the Institute of Internal Auditors ("IIA"), the American Institute of Certified Public Accountants ("AICPA"), and the Association of Certified Fraud Examiners ("ACFE") to help executives, boards of directors, audit committees, and other personnel within the organization to create strong fraud risk management. Entitled **Managing the Business Risk of Fraud: A Practical Guide** (the "Fraud Guidance"), it provides executives with a summary of leading fraud risk management processes and discusses how the different elements of fraud risk management process can work together to create a more effective whole.

The Fraud Guidance also shares leading practices. Among these, we believe the following can be critical:

Setting roles and responsibilities. The organization's boards of directors and audit committee have overall governance responsibility for antifraud programs and controls. However, it is management's responsibility to develop, implement, and monitor those programs. The Fraud Guidance emphasizes the need for an organization's board of directors to ensure that its governance practices set the tone for fraud risk management and to oversee management in its implementation of policies that encourage ethical behavior. The roles and responsibilities for fraud risk management for personnel at all levels of your organization should be clearly defined. We believe that the board and audit committee should ask management tough questions to understand more fully what the antifraud programs entail and to confirm what management is doing to ensure that they are effective.

While many organizations have some policies and procedures to address fraud risks, common opportunities for performance improvement in this area include:

- Implementing effective board of directors oversight of fraud risk management
- Establishing a formal fraud control policy/strategy
- Appointing an executive-level member of management responsible for fraud risk management
- Formalizing roles and responsibilities of the board, audit committee, management, and staff

Assessing fraud risk. Performing regular fraud risk assessments is in the cornerstone of an effective fraud risk management program. The Fraud Guidance recommends that an organization's fraud risk assessment address the relevant key areas and be tailored to its size, complexity, industry, and goals. Your organization should perform and update its risk assessment regularly to understand fraud risk and specific risks that directly or indirectly apply to your organization. For example, if your organization is facing a period of change due to the effects of the economy, review how corporate restructuring — specifically the staff responsible for key financial activities — and other management decisions might affect your risk exposure.

The Deloitte Forensic Center's 2008 study, *Ten Things About Fraud Control*, indicated that both more and less effective organizations have significant opportunities to enhance the quality of their fraud risk assessments. Common opportunities for performance improvement in this area include:

- Involving personnel at all levels
- Focusing on the risk of management override of internal controls
- Conducting fraud risk assessments for key business units and key countries
- Performing detailed fraud risk assessments, the identification of specific fraud schemes
- Linking fraud risks to mitigating control activities

Monitoring key metrics. During the fraud risk assessment process, leading companies focus on monitoring key metrics related to common fraud activities, especially those involving financial reporting. Tracking significant changes in revenue or inventories, for example, can often lead to the discovery of fraudulent activities.

Tapping an executive champion. Effective antifraud programs rely on all employees of an organization having an understanding of their responsibility for fraud control. However, the strongest antifraud programs and controls are driven from the executive level. A positive and supportive tone at the top — reinforced by executive behavior that aligns with corporate ethics and compliance requirements — can help enhance employees' awareness of fraud and clarify expectations from the boardroom to the front-line staff.

When asked "what particular activity would most benefit your organization to adjust for the fraud risk presented by the current economic environment," over 1400 respondents of the Dbriefs webcast offered wide-ranging suggestions:

- A more robust fraud risk assessment — 21.5%
- Internal audit expanding monitoring efforts — 20.3%
- Enhancement of fraud helpline/whistleblower reporting — 6.3%
- Fraud awareness training throughout the organization — 38.7%
- More involvement/oversight from the audit committee — 2.9%
- NA/Do not know — 10.3%



Conducting investigations in economic downturns

Evaluating whether to conduct an internal investigation has become a more complex process in the wake of recent statutory changes in state and federal laws. With allegations of financial fraud, it is imperative that organizations consider carefully how to approach the allegations. Specifically, management should consider the extent and nature of the allegations, the alleged perpetrators, the expertise needed to investigate, and any associated business risks.

In addition, management should evaluate both the qualitative and the quantitative materiality of the allegations — most organizations have a tendency to focus on just the quantitative materiality to drive their investigative decisions. The landscape is changing and federal and state disclosure obligations have become based more on qualitative materiality rather than quantitative.

In economic downturns, organizations may choose to conduct investigations themselves in order to lower costs. Organizations with strong internal investigation plans and protocols may be better prepared to conduct an effective and efficient response.

Three phases of an investigation. Once management has elected to conduct an internal investigation, three phases of an investigation generally include:

- **Strategic planning.** Without a clear strategy, your organization may do more harm than good by conducting an inadequate or deficient investigation. Over the past few years, there have been multiple examples of companies and/or management that have been held responsible for conducting deficient investigations. Thorough planning involving inside counsel, information technology, human resources, outside legal counsel and/or professional consultants can be essential. In fact, most companies should consider developing fraud investigation protocols in advance to ensure comprehensive planning prior to the commencement of an investigation.
- **Implementation.** Management should focus on the collection of information through electronic discovery, review of accounting records, identification of key information sources, and interviews. Prior to conducting interviews, the sequence of interviews should be carefully considered and independent outside counsel may need to become involved in the investigation to preserve privilege and maintain independence. For instance, in most circumstances, information seeking interviews should precede admission seeking interviews so that fact gathering is completed as soon as possible.
- **Reporting process.** Management should provide regular updates about the investigation to key oversight bodies (e.g., an independent investigation committee, audit committee, or board of directors). Issues, such as the frequency of updates, confidentiality, privilege, and discovery, should also be considered during the reporting process. For example, it is important to determine whether internal reporting will be oral or written. There are pros and cons to each approach that should be weighed carefully with the assistance of counsel in light of the underlying facts and the investigation.

Self-reporting of financial fraud. As we see more aggressive investigations by regulators, there are increasing benefits to self-reporting any financial fraud to relevant governmental agencies (i.e., SEC, DOJ) promptly. In fact, many federal statutes have been rewritten

and relevant governmental agencies have published guidelines recognizing that a factor in measuring the culpability of a company and/or management is self-reporting and voluntary disclosure.

You can reverse at least some effects of an economic downturn.

Fraud does not diminish or disappear when the economy sputters; in many cases, it actually increases. But neither your organization nor its reputation need fall victim to this trend. By adopting a leading-practice approach to designing and implementing antifraud programs and controls, your organization can reduce the risk of fraudulent activity along with other potentially damaging legal, financial, and reputational effects.

Assessing your fraud risks can help create greater awareness of where your organization should improve financial systems and processes. It can also help your workforce understand the impact fraud can have on the bottom line and their lives. Using such an approach, your company can ultimately establish a culture of ethics, compliance, and accountability that can withstand the ebb and flow of today's global economy.

Many companies apparently have room to improve their antifraud programs. According to participants of the Dbriefs webcast, less than half of the 1200 respondents (46%) believe their organization has established protocols for conducting investigations, including identifying resources available to use.

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