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Financial Statement Fraud

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Taking Another Look at Perpetrators and Their Schemes—Can a Testifying Expert Witness Rely on the Financial Statements and/or Other Financial Reports Provided?

For more than a decade, the Association of Certified Fraud Examiners (ACFE) has published its report on global occupational fraud. The term occupational fraud refers to frauds that are committed by individuals against the organizations that employ them. Occupational fraud is formally defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. The purpose of this article is to take a deeper dive into understanding who are the perpetrators of financial statement fraud schemes and the methods by which financial statement fraud is perpetrated.

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The ACFE's "Occupational Fraud 2022: A Report to the Nations" is the 12th edition of the report (available as a free download from www.acfe.com). The report is based on the results of an online survey opened to 53,118 Certified Fraud Examiners (CFEs) from July to September 2021. Survey respondents were asked to provide a narrative description of the single largest occupational fraud case they had investigated since January 2020 and the ACFE received 2,110 usable responses that formed the basis of its report.

In September 2022, the ACFE published a PowerPoint presentation intended to serve as a companion resource to its 2022 report. Many authors have extracted, commented on, and published regarding the key elements of the 2022 report. The primary findings of the report include:

- Organizations are estimated to lose 5% of revenue to fraud each year.
- The median loss per case is $117,000 and the average loss per case is $1,783,000.
- 42% of the reported frauds were detected by tips (more than one-half coming from employees, making hotlines an effective anti-fraud control) while only 4% of frauds were detected by external audits.
- Asset misappropriation (theft) schemes were the most common (86% of cases) but the least costly ($100,000 median loss) occupational fraud schemes.
- Financial statement fraud schemes were the least common (9% of cases) but the costliest ($593,000 median loss) occupational fraud schemes.

The purpose of this article is to take a deeper dive into understanding who are the perpetrators of financial statement fraud schemes and the methods by which financial statement fraud is perpetrated. According to the ACFE report, while company owners and/or executives committed only 23% of occupational frauds, they caused the largest losses—owners and/or executives caused median losses of $337,000 as compared to managers causing median losses of $125,000 and employees causing median losses of $50,000. Further, nearly half of all occupational frauds come from four departments: operations 15%; accounting 12%; executive/upper management 11%; and sales 11%.

According to the ACFE report, only 6% of perpetrators had a prior fraud conviction and 85% of fraudsters displayed behavioral red flags of fraud. Seventy-three percent of occupational fraud perpetrators were male, who caused median losses at least 75% higher than female fraudsters caused. The size of the fraud was strongly correlated with the perpetrator's length of service. Fraudsters with at least 10 years of tenure at the victim organization caused median losses of $250,000, five times the median loss caused by perpetrators with less than one year of tenure.
This is highly supportive of the logical, anecdotal evidence that the longer a person works for a company, and the higher the position they attain, the more they are trusted and the easier it is for them to defraud the company.

Considering all of the statistics cited above, companies, their financial analysts, accountants, and/or auditors need to carefully consider the company's exposure to the following hypothetical 'high-fraud-risk' company employee: a male owner/executive; with the ability to access and potentially override a company's internal controls, accounting books and records, income tax returns, and/or financial statements; with no prior fraud connection; displaying behavioral red flags of fraud (living beyond their means, encountering personal financial difficulties, unusually close relationships with vendors/customers, excessive control issues, "wheeler-dealer" attitude, etc.); and with more than 10 years of employment in the company's accounting department.

To provide the reader of this article with a better understanding of financial statement fraud, I next turned from the ACFE report to a text authored by Professor Howard M. Schilit, Financial Shenanigans, Third Edition.[2]

In the third edition of his essential book on financial shenanigans, Professor Schilit explains that senior management at publicly traded companies, yearn to report positive news and impressive financial results that will please investors and drive the share price higher. He notes that while most companies act ethically and follow prescribed accounting rules when reporting their financial performance, some take advantage of gray areas in the rules or ignore the rules altogether in order to portray their company's financial results in a misleadingly positive way.

The original 1993 edition of Professor Schilit's *Financial Shenanigans* textbook introduced readers to the world of corporate chicanery in the form of seven "Earnings Manipulation Shenanigans". The 2002 edition built on the original framework by identifying new techniques and presented the worst offenders of the 1990's. With the wave of accounting frauds, restatements, and other financial reporting improprieties that have repeatedly occurred, Professor Schilit's third edition identified many new techniques companies use to mislead investors.

The third edition goes far deeper into the corporate bag of tricks than the earlier editions did, to give readers a comprehensive look at the various kinds of scams that are prevalent today. Professor Schilit groups these financial report shenanigans into three categories:

1. **Earnings Manipulation Shenanigans**, which reveal how companies manipulate the Statement of Income to report higher revenue, inflated profits, or improperly smoothed income.
2. **Cash Flow Shenanigans**, which discusses the tricks used by companies to report misleadingly high cash flow measures, including cash flow from operations and free cash flow.
3. **Key Metrics Shenanigans**, which exposes how companies fool investors by showcasing misleading metrics that are promoted as key measures of business performance or economic health.

The balance of this article focuses on the earnings manipulation shenanigans only as devices that misstate annual financial statements—but readers will find their time well spent by obtaining and reading Professor Schilit's textbook in its entirety.

Professor Schilit explains that investors rely on the information that they receive from corporate executives to make informed and rational securities selection decisions. This information is assumed to be accurate, whether the news is good or bad. Some executives however, he explains, misrepresent the company's performance by manipulating the company's declared earnings. He lists and then drills down on each of (devoting an entire chapter of his book to each) the following seven most common earnings manipulation shenanigans (and he also suggests how skeptical investors can ferret out these tricks). According to Professor Schilit, here are the seven most common earnings manipulation shenanigans:

1. Recording revenue too soon
2. Recording bogus revenue
3. Boosting income using one-time or unsustainable activities
4. Shifting current period expenses to a later period
5. Employing other techniques to hide expenses or losses
6. Shifting current period income to a later period
7. Shifting future expenses to an earlier period

This list of earnings manipulation shenanigans sets forth the various ways that the hypothetical "high-fraud-risk" company employee described earlier in this article could use a variety of techniques to give investors, lenders and other creditors, and/or employees (in a public company) or owners, lenders and other creditors, and/or employees (in a private company), the mistaken impression that the company is performing better (or worse) than the economic reality by inflating current period earnings (or inflating future period earnings). Quite simply, as Professor Schilit elaborates, the executive simply pushes more revenue or gains into the current period or shifts expenses to a later period to exaggerate the current period's earnings.

So, what are readers to take away from the author's juxtaposition of the ACFE's occupational fraud report and Professor Schilit's lessons learned from wrongful financial reporting? Paraphrasing (and crediting) Professor Schilit's postmortem analysis it is this: the financial reporting process sometimes fails (or is deliberately manipulated to fail) and accountants, valuation analysts, auditors, investors, and others must use the failures outlined by the ACFE, Professor Schilit, and/or others to learn from past financial frauds and financial statement failures in the expansion of their knowledge base.

In business interruption, lost profits, and other economic damages engagements or in a business valuation engagement, the expert and/or appraiser could conclude (and/or be asked to assume) that the provided financial statements (or the provided financial reports extracted from the accounting books and records) fairly presents the subject company's financial condition (and/or are of types reasonably relied upon by experts in similar engagements).

Depending on the engagement facts and circumstances and/or the professional's scope of work, the expert and/or appraiser may need to perform additional due diligence regarding the financial statements (and/or extracts of the accounting books and records) provided. There may be times when, due to unique facts and circumstances, the expert and/or appraiser might need to consider whether the preparers of the financial statements (and/or the accounting books and records) have misstated the subject company's financial condition and/or that financial shenanigans may exist.

In engagements involving expert testimony, the expert and/or the appraiser may also believe and/or assert that, absent indications to the contrary and/or unless and until shown to the contrary, the provided financial statements (and/or provided extracts of accounting books and records) can be accepted without independent verification and are acceptable evidence for the Court.

[1] Occupational Fraud 2022: A Report to the Nations; Association of Certified Fraud Examiners (ACFE); Page 6; Downloaded from https://acfepublic.s3.us-west-2.amazonaws.com/2022+Report+to+the+Nations.pdf; October 14, 2022.
[2] Schilit, Howard M. and Perler, Jeremy; *Financial Shenanigans, How to Detect Accounting Gimmicks and Fraud in Financial Reports – Fully Revised and Updated Third Edition;* The McGraw Hill Companies; New York, NY; 2010.

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