The red flags of fraud

Faisal Sheikh explains how accountants can identify the indicators of fraudulent activity.

Faisal Sheikh is an economics graduate and Fellow of the Association of Chartered Certified Accountants and Institute of Financial Accountants. He has more than 15 years' professional accounting, auditing and consulting experience gained primarily in small to medium-sized enterprises and the international not-for-profit sector. Faisal has worked for several leading UK business schools and is currently a lecturer in accounting and finance at Salford Business School, where he is actively researching accounting fraud for his PhD. He has recently published his first book, *A Refresher in Financial Accounting* (tinyurl.com/yd75evtk). E: f.m.sheikh@salford.ac.uk

TEN SECOND SUMMARY

1. **In 2017, fraudulent activity in the UK has surpassed £1bn for the first time since 2011.**
2. **The fraud triangle shows that three elements must be present.**
3. **Accounting fraud supplies an implicit gain through several means.**

Fraud has probably existed since the beginning of trade and commerce. Fraud includes "intent, deceit, breaking the law or violating regulatory framework(s), and harm to its victim(s)". As an indication of its impact, in 2017 KPMG noted: "The total cost of fraudulent activity in the UK has surpassed £1bn for the first time since 2011."

The *Oxford English Dictionary* defines fraud as: "Wrongful or criminal deception intended to result in financial or personal gain." To bring more focus, CW Jackson, in his book *Detecting accounting fraud* suggests that accounting fraud (also referred to as "corporate fraud", "financial reporting fraud" or "financial statement fraud") is a particular kind of fraud that necessitates the manipulation of financial statements.

Why fraud occurs

The studies of American criminologist Donald Cressey included white-collar crime, and in his book, *Other People's Money*, he formulated the theory of the ***Fraud Triangle*** which shows the three elements that must be present for occupational fraud and other unethical behaviour to occur.

We can look at the three elements in a little more detail.

- *Pressure* is what motivates an individual to undertake fraud and can include almost anything such as a lavish lifestyle or addiction.
- *Opportunity* is the method an individual uses to commit fraud. This is usually created by poor internal controls, weak management oversight or the abuse of authority.
- *Rationalisation* is the justification an individual uses to commit fraud.

If *all* factors exist, fraud will potentially take place. Consequently, the key to preventing fraud is breaking the fraud triangle.

Red flags

A red flag is one or more conditions that are abnormal in nature or differ from the norm. It is an indication that something is wrong and should be further investigated. I will begin with generalities or what I call "soft red flags" and move onto specific accounting or what I term "hard red flags".

Common internal control weaknesses that can operate as red flags include: deficient segregation of duties; inadequate physical safeguards; unsatisfactory independent checks; improper authorisation of documents and records; override of existing controls; and a faulty accounting system.

Analytical irregularities are relationships that do not make sense and appear to be unreasonable. These include large or small transactions that occur at strange times that may involve personnel not normally associated with them. Examples of analytical irregularities include:

- company assets sold below market value;
- a large number of bank accounts;
- downsizing in a healthy economy; and
- unexpected overdrafts or shortages of cash.

Operational anomalies are curious events concerning a company's operations. Although they may not be within the control of management, they warrant attention as a red flag for possible fraud. Some of these anomalies are:

- shortage of capital;
- repeated changes in lawyers or seeking multiple expert opinions;
- frequent changes in senior management;
- high staff turnover; and
- significant changes in employee attitude or lifestyle.

Cash and payroll issues

Because cash is the asset most commonly stolen, accountants should focus attention on the red flags of cash embezzlement and accounts receivable and these may include:

- an unnecessary number of voids, discounts, and returns;
- unexpected activity in an inactive bank account;
- customer complaints about notices for defaulting or non-payment of accounts;
- inconsistencies between bank deposits and deposits posted to the company records;
- an unusual quantity or extent of expense items or reimbursements to staff or senior management;
- unusual cash transactions;
- frequent write-offs of accounts receivable; and
- an increase in the allowance of doubtful accounts.

Payroll is normally an automated or outsourced function that is open to collusion and fraud. Red flags in this area include: overtime claimed during a quiet period or by staff who would not normally do so; negative and material variations between standard and actual wages; staff with little or no payroll deductions; and "ghost employees".

Purchasing or procurement results in a significant outflow of monies within most companies and is susceptible to fraud. Similarly, an organisation's inventory can be vulnerable to theft. Red flags that the procurement and inventory functions are being manipulated include:

- a rising number of complaints regarding products or service;
- an increase in purchasing inventory but no growth in sales;
- peculiar inventory reduction;
- the proliferation of scrap items and reorders for the same materials; and
- surplus or slow-moving inventory.

The reporting function

The rationale for manipulating the financial reporting function or engaging in accounting fraud is different from the embezzlement of company assets.

Accounting fraud does not result in an explicit financial advantage to one individual. Instead, it supplies an implicit gain in the shape of higher share prices, superior stock options for managers and continued lines of credit. However, red flags are often present in accounting fraud, just as they are in asset misuse schemes.

The following are some of the red flags seen in accounting fraud:

- aggressive revenue recognition;
- extraordinary and profitable transactions towards the end of reporting periods;
- boosting profits by selling undervalued assets or recording one-time events as operating income;
- persistent negative cash flows while reporting positive or growing profits;
- expenses rising quicker than revenues or sales;
- use of misleading classifications;
- capitalising operating costs;
- pressure to report positive or growing profits;
- material and growing transactions with related parties;
- regularly changing accounting policies such as depreciation technique; and
- using special purpose entities to improve gearing.

Conclusion

I differentiated between fraud and accounting fraud and introduced the ***Fraud Triangle*** which has been extended by introducing other risk factors such as capability in a fraud diamond model. The red flags above are not an exhaustive list and as practitioners we should be prepared to examine the double entry of transactions to establish fraudulent activity.

Prevention is better than cure and the ancient Greek Sophocles gracefully stated an insight for this burgeoning problem: "Rather fail with honour than succeed by fraud."

FURTHER INFORMATION

References and additional reading.
Essentials of corporate fraud, T Coenen: tinyurl.com/y7gt6czv
Other People's Money, D Cressey: tinyurl.com/y72cob9m
Detecting accounting fraud. Analysis and ethics, CW Jackson: Pearson: tinyurl.com/y7oqqfky
Detecting Financial Reporting Fraud: The Impact and Implications of Management Motivations for External Auditors – Evidence from the Egyptian Context, R Kassem: tinyurl.com/ycxzg7t5
KPMG Fraud Barometer 2017: tinyurl.com/j7hn8cy
History of forensic accounting, M Rasey.
Accounting principles, JJ Weygandt, DE Kieso, and PD Kimmel: tinyurl.com/ycogjm5l

THE FRAUD TRIANGLE

A framework for spotting high-risk fraud situations