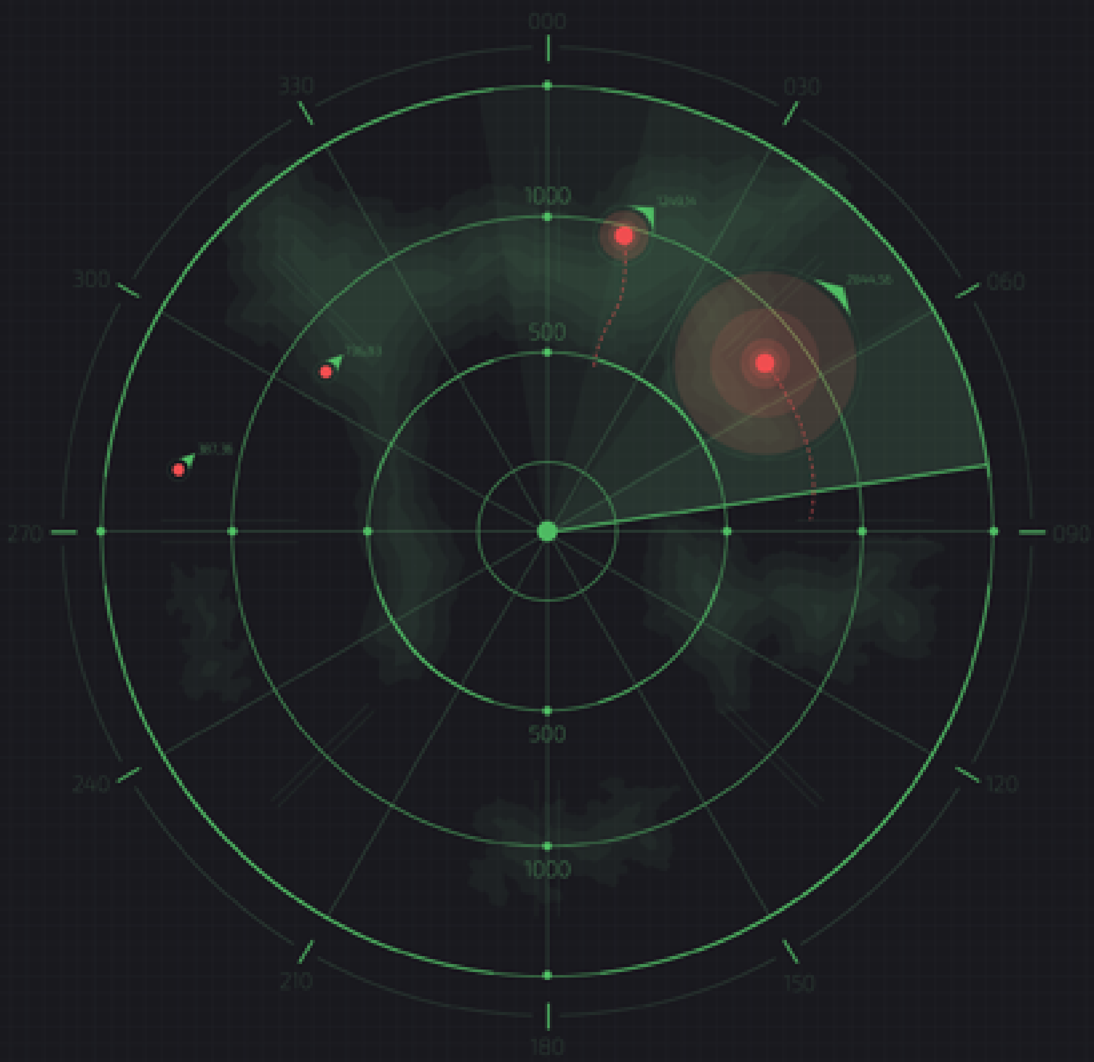

The risk of financial statement fraud in the wake of COVID-19

Introduction

The spread of COVID-19 has resulted in an abrupt halt in the global economic activity. The impact of this forced lockdown is expected to result in a severe economic downturn with the contraction of global economy by 3 percent in 2020[1] and a low growth rate forecast of 0.8 percent for the Indian economy for the current fiscal year 2020–21[2].

Corporates worldwide are struggling significantly to manage their operations, generate cash, and keep their businesses afloat. This is adding to the pressure of meeting performance targets and market / stakeholder expectations. As a result, organisations may be tempted to take desperate measures including manipulating the books of accounts to avert corporate failure.

Regulators have already expressed their concerns about the expected increase in corporate frauds as a result of the crisis, for instance, the US Securities and Exchange Commission (SEC) and the US Department of Justice (DOJ) have issued a notice that they will be actively investigating and prosecuting COVID-19-related frauds[3]. Further, from our point of view and as witnessed in multiple cases in the past, instances of corporate cover-ups through innovative accounting or manipulation in the books of accounts spanning years tend to come to light during a downturn/recession.

Stakeholders therefore need to be vigilant for financial statement fraud schemes. Some common types of financial fraud schemes are listed below.

01. https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression

02. https://economictimes.indiatimes.com/news/economy/indicators/fitch-ratings-sees-india-growth-slipping-to-0-8-in-fy21/articleshow/75313106.cms

03. https://www.justice.gov/ag/page/file/1258676/download

Key financial statement fraud schemes in the context of Covid-19

1. Revenue recognition fraud

With the suspension of business operations and lower consumer demand, revenue for most companies is likely to be impacted significantly, with industry estimates pointing to a 10 percent reduction[4]. The gloomy outlook may induce companies to either record fictitious revenue or recognise revenue prematurely to show better than actual results. With losses being incurred due to the disruption caused by COVID-19, a surge in insurance claims by affected companies towards loss of profit and business interruption is expected. Companies may record such income even in the absence of acceptance of such claims by insurance companies, or may report higher claims, leading to inflation of income.

2. Inventory overstatement

The country-wide lockdown in India coupled with the uncertainty over the revival period of consumer demand may result in a drastic fall in the net realisable value of inventory for certain companies. For instance, the poultry industry in India is estimated to incur a loss of INR 22,500 crores over a period of 2.5 months owing to the lockdown[5]. The management may not fully recognise such reduction in the net realisable value, resulting in overvaluation of inventory and increased profit margins in the financial statement. Further, count of physical inventory as a year-end exercise on or around 31 March 2020 would not have been possible owing to the lockdown, thereby increasing the fraud risk pertaining to inventory.

3. Manipulation of key estimates, impairment, provisions and assumptions

COVID-19-induced disruption may impact the valuation of multiple items in the financial statement including goodwill, financial instruments, Property, Plant, and Equipment (PPE), fixed assets, loans, trade, and other receivables. Companies may deliberately underplay this impact on its business operations and not appropriately take into account the impact on financial statements.

4. Inadequate disclosure

As a result of the disruption caused by COVID-19 in the global economic environment, there could be a consequential impact on the disclosures in the financial statements, for instance, impairment of assets, contingent liabilities, accounting estimates, going concern considerations, valuation of tangible, and intangible assets etc.. Companies may be motivated to avoid disclosing the full impact of COVID-19 in their financial statements for certain aspects such as counterparties' ability to satisfy contractual obligations, post balance sheet events impacting the financial position at the end of the financial year. While the adequacy and sufficiency of such disclosures is critical to the true and fair view of financial statements for stakeholders/investors, the estimated significant impact of COVID-19 could pressurise the management for non-disclosure on key matters to meet performance targets or market expectations.

5. Inappropriate expense capitalisation

In order to show better than actual profits, companies may be tempted to defer the recording of expenses or inappropriately capitalise expenses and charge these expenses to the profit and loss account over years as amortisation/depreciation.

04. https://www.indiatoday.in/business/story/most-firms-to-face-10-percent-revenue-loss-due-to-covid-19-cii-poll-1663718-2020-04-06

05. https://www.indiatoday.in/business/story/covid-19-with-projected-losses-of-rs-22-500-crore-indian-poultry-sector-seeks-centre-s-intervention-1662872-2020-04-03

Key considerations: What can stakeholders do?

A Greater scrutiny of the financial statement compilation process and validation of key estimate

Adequate internal controls with regard to preparation of financial statements such as segregation of duties and maker-checker controls should be followed. The board of directors and the audit committee should be vigilant and oversee the process of financial statement preparation process with emphasis on matters where management discretion can be high. They should also scrutinise high-value complex or "extraordinary" transactions, either positive or negative, which offset results from operations.

B Obtaining independent expert opinion on key matters

Certain aspects in the context of the disruption may be technical, for instance, estimation of impairment loss, Expected Credit Loss (ECL), valuations, future outlook and risk-related disclosures pertaining to the impact of COVID-19, and contingent liabilities. Considering the fact that these items could have a material impact on the financial statements, the management may consider obtaining independent expert opinions on such matters than merely applying their own discretions.

C Enhanced oversight by auditors

The auditors should be vigilant and exercise a higher level of scepticism during the audit of the financial statements post COVID-19. The auditor should extend their audit procedures to ensure that financial statements are not materially misstated with aspects linked with the pandemic. Institute of Chartered Accountants in India (ICAI) has issued specific guidance on the impact of COVID-19 on the audit of financial statements, which the auditor should comply it [6]. The auditor should also evaluate the reasonability of accounting estimates made by the management and appointed independent experts with an attitude of professional scepticism. Disclosures pertaining to the financial impact of COVID-19 should be evaluated to ascertain if they reflect the entity's actual financial position.

D Oversight by independent directors

Independent directors should oversee, scrutinise, challenge, and validate key aspects related to COVID-19 and their impact/disclosure in the financial statements. It is pertinent that all the matters be reported appropriately and more so in the context of successive reforms in the form of including the overhaul of the Companies Act (where SEBI regulations have placed greater responsibility on independent directors through increased representation on the board of directors and other key committees, oversight of related party transactions, etc.).

E Continued oversight and evaluation by external stakeholders

The external stakeholders of the company such as lenders and investors could undertake a focussed analysis of financial statements including ratio, vertical, horizontal, and cash-flow analyses for correlating the numbers in the financial statements to study the patterns and ascertain red-flags, if any.

The COVID pandemic has adversely impacted organisations and many have lowered their growth-related guidance and estimates. At such a time, while it may be tempting to showcase better performance through manipulation of financial statements, organisations must understand that regulatory scrutiny will remain high and chances of such actions being discovered are likely, resulting in the erosion of trust by customers and the public at large. Organisations that can uphold ethical business practices are likely to have a better chance of recovering from this crisis in the days to come.

06. https://resource.cdn.icai.org/58829icai47941.pdf

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