

Financial cost of corporate fraud in united states

Law



Financial Cost of Corporate Fraud in United States

As per 2008 Report to the Nation on Occupational Fraud and Abuse, “ the median loss caused by occupational fraud was \$175, 000 with more than one quarter of frauds involved losses of at least \$ 1 million” (ACFE, 2009, p. 4). It is difficult to identify all associated financial cost with corporate fraud but the study reveals that on average, a US organization loses 7% of its annual revenues due to frauds (ACFE, 2009, p. 8).

As per the ACFE study, out of total fraud cases in 2008, 61. 5% of the companies had a formal code of conduct in place but even then, the fraud occurred (ACFE, 2009, p. 36). This shows that having well defined policies, procedures and code of conduct does little to mitigate the risk of fraudulent activities. However, the study reveals that fraud training for employees and managers reduces the risk of fraud by 52% and 56% respectively (ACFE, 2009, p. 37). Thus, ethical training may be employed as a control against fraud. However, this may not be adequate and other controls must be put in place for early detection of fraudulent activities.

Red Flags

Financial statement fraud is the biggest category of frauds and the one associated with highest losses. Financial statements from different periods can be used to identify red flags, which may provide an idea that fraud may be occurring or a deviation from normal routine. Some of these components from financial statements are described below:

a. Receivables

Receivables can be booked fictitiously or increased without underlying trade/ transaction to show an overstated balance sheet and asset position. The management may want to show better results for the year, and thus may be <https://assignbuster.com/financial-cost-of-corporate-fraud-in-united-states/>

tempted to overstate receivables. This was carried out recently by the CEO of Satyam, an Indian IT outsourcing company. He recorded receivables against selling to fictitious companies; and thus inflated the balance sheet. This type of fraud can be identified by carrying out year to year analysis of changes in receivables, and their collection days. A very large or disproportionate increase in days receivables indicate a red flag that receivables may be inflated fraudulently (Beneish, 1999, p. 10).

b. Depreciation

Depreciation is a non cash expense that reduced income of an organization. A comparison of depreciation expense of last years with current year may indicate a significant change in depreciation expense. Though this may be due to changes in fixed assets, but can also be due to inappropriate changes in existing fixed assets' useful lives (to indicate greater useful life and thus lower depreciation; leading to higher income). Thus, a significant variation should be examined to determine if any fraudulent activity is being undertaken (Beneish, 1999, p. 11).

Fraud Analysis Ratios

Fraud examiners make use of some key ratios to identify red flags in the financial statements. These ratios provide year to year comparison between various parameters which assist fraud examiners and auditors to identify if there is any unusual, exceptional or disproportionate activity going on in the organization.

One of these ratios is Sales Growth Index. It is given as:

Sales Growth Index (SGI)= Sales current year/Sales prior year

As per Harrington, “ Results show that companies that manipulated earnings have a mean SGI of 1. 607 and a median of 1. 411” (Harrington, 2005). The

<https://assignbuster.com/financial-cost-of-corporate-fraud-in-united-states/>

SGI for OHC Medical Center is calculated below:

$$\text{SGI} = \$49,570,000 / \$58,016,000 = 0.85$$

Thus, SGI for OHC does not indicate a fraudulent pattern. It in fact, indicates that the current year's sales revenues are lower than last year. Companies who may manipulate their financial statements tend to increase their sales revenues to show better performance.

References

ACFE. (2009). 2008 Report to the Nations on Occupational Fraud and Abuse.

Association of Certified Fraud Examiners. 7 May 2009.

Beneish. (1999). The Detection of Earnings Manipulation. Retrieved 7 May 2009 from <http://www.bauer.uh.edu/swhisenant/beneish%20earnings%20mgmt%20score.pdf> [Online].