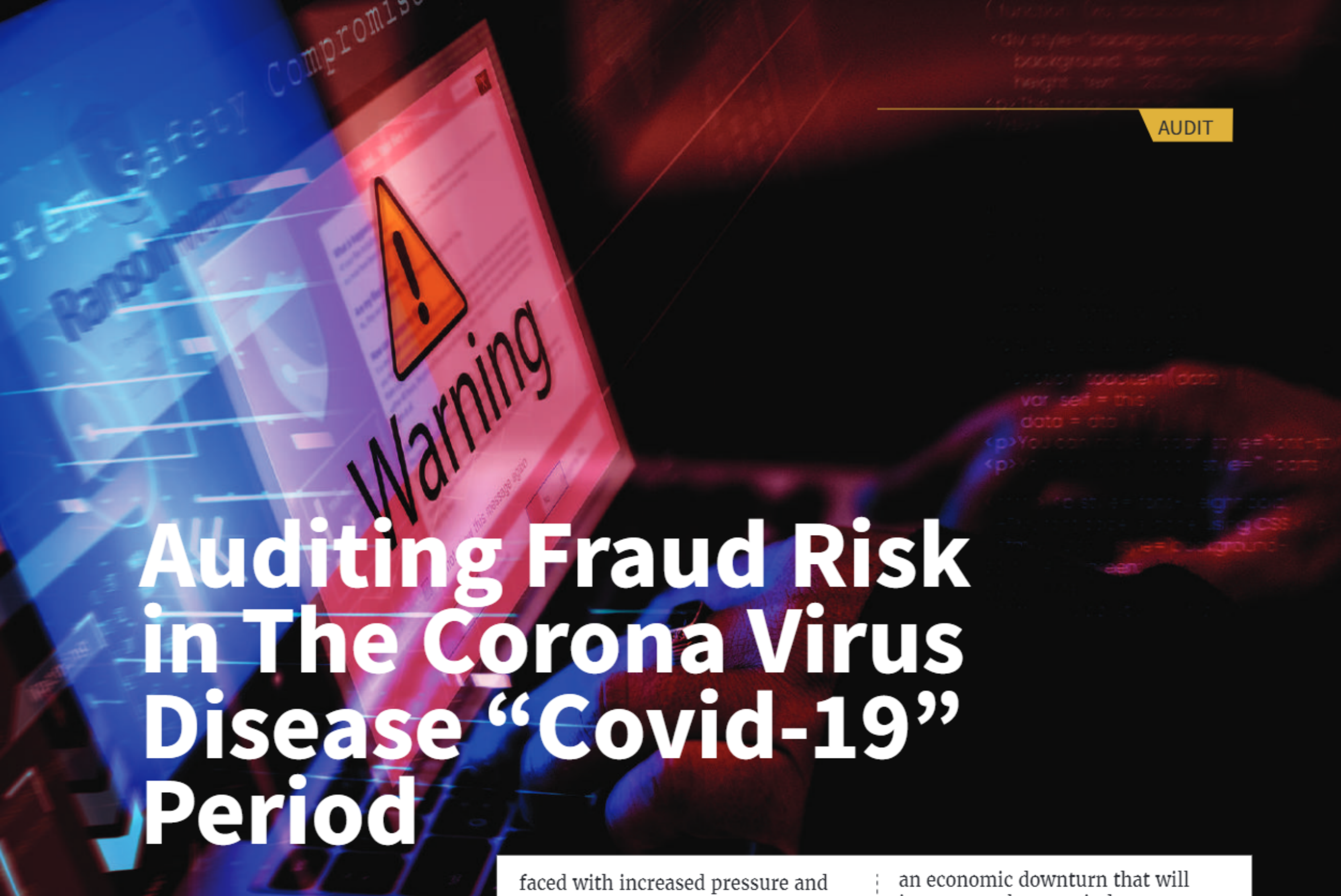


# Auditing Fraud Risk in The Corona Virus Disease "Covid-19" Period

*By Abdallah Mambo Dallu*

The COVID-19 pandemic has resulted in unprecedented social and economic paralysis. Most companies have transitioned to an entirely remote workforce, and while existing technologies have facilitated connectivity via cloud computing and video and teleconferencing services, working in this new environment still poses numerous challenges. It is hard to predict the effects this "new normal" will have on operations because even experts can't say with certainty how long it will take to contain the virus or how long its economic effects will last.

The reality of a crisis is that it often hits when you least expect it. While crises come in many shapes and forms, it is always a major disruption to multiple functions of the enterprise and one with the potential to significantly harm your reputation. It is undeniable that the COVID-19 pandemic is a crisis that has posed extraordinary challenges for companies. While companies are faced with increased pressure and the urgency to respond to constantly changing facts and communicate effectively with stakeholders, it is even more important now for leaders to reinforce the fundamentals in a visible and working manner.

Companies across various industries are experiencing increased operational and financial pressure due to the COVID-19 pandemic. These pressures create a heightened level of economic risks such as:

- Significant reduction in trading
- Loss in revenue
- Loss in profits
- Loss in market demand
- Going concern
- Liquidation and total collapse.

These economic risks may lead to increased motivation or justification to commit fraud, through manipulation of financial results, misrepresentation of facts, misappropriation of assets and other fraud schemes.
Covid-19 and the fraud triangle
Companies should be giving some thought to what otherwise might not have been top of mind; that their organization is susceptible to fraud, even by employees with good intentions. We find ourselves facing an economic downturn that will impact nearly every industry sector, some more deeply than others. With a significant decrease in expected revenue, businesses will need to turn to cost-cutting measures. For most companies, in all likelihood that will involve a reduction in payroll.

Potential sources of pressure, opportunity, and rationalization; the three sides of the fraud triangle, will be present in this economic downturn. While pressure can be a positive force, it can inspire creativity and efficiency, in some situations it can instil fear. Employees will be concerned about the viability of the company and whether it can navigate this unprecedented downturn. One or more employees, from management to staff, might come to believe that falsifying operational or financial information, in the short term, will make the company appear more liquid than it actually is.
While investors likely anticipate that companies might not meet quarterly earnings projections, the temptation may still exist to conceal certain losses or embellish financial performance with the expectation that it can be regained in the coming periods. Most frauds start out small and compound over

several reporting periods; often referred to as a "slippery slope."


### a. Pressure

The first side of the fraud triangle is pressure. Work-from-home mandates can present a unique set of pressures if employees need to balance their job responsibilities with other demands such as home-schooling and caregiving. Reductions in the workforce may prove to be an additional source of pressure if employees are expected to pick up the workload of their colleagues who have been laid off or furloughed. Employees might also face personal financial pressures. Research has shown that one-quarter of people who commit fraud have experienced financial difficulties. Over 22 million people have filed for unemployment over a four-week period due to the COVID-19 crisis. If a family was dependent on two incomes to meet monthly expenses and one spouse is no longer working, the household member who is still employed might feel pressure to find ways to compensate for the loss. Even otherwise honest employees, under stressful circumstances, might commit fraud. When assessing the risks of managing through a crisis, corporate leaders should consider the pressure that employees are under.

### b. Opportunity

The second side of the fraud triangle is opportunity. For example, companies that have introduced cutbacks in departments, such as internal audit or SOX compliance, may come to realize that they are vulnerable. They might not realize the number and types of changes that need to be made to the design and operation of its internal controls to address changes in risks for areas such as credit and liquidity. Companies should reassess their period-end reporting processes, among other key controls. Employees might find ways to take advantage of these weaknesses. Another area to pay close attention to is management override of controls. Employees may be able to manipulate certain manual processes that could be overlooked in a remote work environment.

### c. Rationalization

The third side of the fraud triangle is rationalization. This allows people to convince themselves that they are not doing anything wrong or that their actions are justified. In some cases, the employee can justify his or her actions because they are altruistic: "I'm doing it for the company." This would be the case in situations in which the employee falsifies or "tweaks" the numbers to make the company appear to be in a better position than the actual financial performance would otherwise indicate. Personal pressures, including those discussed above, might lead an employee to misappropriate assets by telling himself or herself that "no one will notice," "I'll pay it back," or "it's not a big deal." Others might rationalize stealing from their employer because they decide that the company owes it to them.

### Susceptible areas of fraud

For some, as these financial pressures mount, the line separating acceptable from unacceptable behavior can become blurred. At the same time, controls such as segregation of duties may be weakened due to work force displacement or distraction. Organizations have to be sensitive to the pressures that could result in financial statement manipulations at the corporate or operating subsidiary level. Further, management should recognize that the environment created by adverse events such as COVID-19 could lead to increased fraud by employees (e.g., asset misappropriation or bonus maximization schemes). In particular, Auditors should consider the following potential financial statement fraud risks:

*"These economic risks may lead to increased motivation or justification to commit fraud, through manipulation of financial results, misrepresentation of facts, misappropriation of assets and other fraud schemes.*

i. **Overstatement of revenue** – To make up for decreased trading, companies may endeavor to deliberately fabricate revenue to boost bottom lines and show how management was able to persevere in a challenging customer/ business environment.

ii. **Understatement of allowances and reserves** – Companies have numerous valuation accounts, allowances, and reserves including, but not limited to, those for inventory, accounts receivable, insurance claims incurred but not recorded, income taxes, and contingent liabilities. Management may be motivated to intentionally manage these reserves to avoid additional charges to the bottom line.

iii. **Manipulation of valuations and impairments** – Organisations use forecasts as a key element in the valuation of assets such as inventory, goodwill, financial instruments, investments (such as portfolio companies and debt/equity securities issued by entities), and certain long-term contracts. Disruptions to supply chains and the volatility in financial markets may result in organizational challenges to record such assets at their net realizable or fair values. Given the inherent uncertainty in valuing such assets in turbulent times, some companies may take advantage and consider intentionally delaying the recording of such losses or may attempt to overvalue certain assets in order to generate insurance recoveries.

iv. **Restructurings and "big bath" charges** – Given the strong probability of outbreak-related financial losses, affected companies may seek to write-off underperforming assets and/or record charges as part of larger organizational restructurings, sale, or closure of parts of their business that are either marginally associated with the impact from COVID-19 or not associated at all.

v. **Capitalization of expenses** – It may be tempting for companies to capitalize expenses and deduct them over several accounting periods rather than expense them immediately. Outbreak-related costs may be substantial, and executives may be inclined to spread the costs out over a few years, rather than expensing them when incurred.

vi. **Disclosure fraud** – Companies may be motivated to avoid fully disclosing the impact of COVID-19 on its overall business results, particularly with respect to risks, uncertainties, contingencies, and representations contained in their public statements, and regulatory filings. For example, particular concerns may arise regarding companies' or their counterparties' ability to satisfy contractual obligations. The disclosure should also include an assessment of whether reliance on force majeure provisions or common law principles of non-performance may apply. The adequacy and sufficiency of such disclosures may lead to claims of securities fraud by regulators and investors.

vii. **Margin manipulation** – Many companies are already experiencing significant decline in revenues, closures of plants, facilities, and storefronts, reduced transaction fees, and declines in assets under management, all while paying their employees and supporting current-state cost structures. Each of these actions increases the risk that an organisation's profit margins could be manipulated. There are many ways in which this can be done, but organisations should consider these risks and be aware of how it could potentially happen within their company.

viii. **Internal Controls over Financial Reporting (ICFR)** – The current economic environment may result in increased fraud risks related to internal controls. As many organisations move to a virtual work environment, there is a significant risk that fraudsters may find new ways to override existing internal controls, especially those critical to ICFR. Such controls may include, but are not limited to segregation of duties, delegation of authority, and information systems access. With a potential decrease in workforce, the rapidly changing nature of working environments, and the possibility of changes in individual responsibilities, modifications to existing controls may not happen with the same speed, or new controls may be implemented without sufficient testing of their design and/or effectiveness. Accordingly, the nature, timing, and extent of diligence performed in a changing control environment creates an increased opportunity for fraud.

## In Conclusion

The coronavirus pandemic has taught us all to be on high alert during a time of uncertainty. The key to managing this uncertainty is adaptability. All entities have been affected by the pandemic in some way, whether it's changes in internal control caused by remote-working conditions or a decline in operations at the peak of the outbreak. As many businesses shifted to remote operations, the risk of fraud may have increased. For purposes of a financial statement audit, fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in the financial statements. Considering the fraud risk triangle, the current environment provides individuals the incentive or pressure to perpetrate a fraud, opportunity to commit fraud, and rationalization to justify a fraudulent action. With all of these factors present, the risk of fraud is substantially heightened.

As a professional accountant you have many responsibilities, as mentioned above. While this realization may be intimidating, it can also be inspiring. This time of crisis is an opportunity for accountants to be looked at and admired as ethical leaders, and to demonstrate that they uphold the public interest. Accountants have a wide-ranging role in society and as a result, their skills and values can bring positive change through their work. The following are important reminders:

i. **Be alert** - The risks of fraudulent activities have increased significantly. Remain alert to threats to compliance with the fundamental principles. Professional accountants may be required to reconsider safeguards and the expectations of a reasonable and informed third-party.

ii. **Be an advocate for the public interest** - Reminding others of these threats and helping them to identify these issues timely will assist in the longer-term viability and success of their employing organizations and clients. Add ethical considerations as a regular feature to written and verbal communications to continually amplify the messaging.

iii. **Increase awareness** - Professional accountants are encouraged to promote these and other publications. This may help create awareness of ethics issues.

*CPA Abdallah Mambo Dallu, Chief Internal Auditor & Compliance Officer; Umma University*
*Abdhallamambo@yahoo.com*