

# COVID-19 and Financial Fraud: What Brazilian Companies Can Learn from Previous Crises

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The COVID-19 pandemic is expected to have a more negative impact on the Latin American and Caribbean economies than previously anticipated, with an estimated 9.4% reduction in real GDP in 2020<sup>1</sup> based on current projections. Similar to the aftermath of the 2009 global financial crisis, public companies should also prepare for a related spike in accounting fraud misconduct, specifically an increase in the misrepresentation of books and records.

## Fraud Scenarios & Lessons Learned from 2009

According to ACFE's 2009 Fraud Report, financial statement fraud increased by 16.8% during the 2009 recession.<sup>2</sup> More recent fraud schemes have revolved around inflated revenues and revenue recognition, as seen with Valeant (Salix) Pharmaceuticals (2015),<sup>3</sup> Wells Fargo (2017),<sup>4</sup> and most recently, financial fraud allegations at Wirecard (2020).<sup>5</sup> While these schemes all involved revenue-related issues, they often also included falsified and forged invoices, contracts, fictitious customers, or inflated sales to existing customers. No matter the scheme, all revealed significant weaknesses in a company's control environment.



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Beyond revenue-related income statement fraud schemes, other types of fraud are likely to have material impact on a company's financial statements:

- **Manipulating inventory counts or cash accounts**
- **Reporting of assets not under control of the reporting entity**
- **Inflated unrealized gains**
- **Manipulating assumptions used to calculate impairment of assets**
- **Underreporting of debt obligations**
- **Deflation of accounts payable**
- **Inadequate disclosure of going-concern**

## **Internal Controls: Addressing the Risk of Fraud in Financial Statements**

Companies must understand the risks resulting from the COVID-19 environment, and act to mitigate these risks, particularly as related to financial fraud. Here's how:

### **1 Strengthen the Risk Assessment:**

The company should define the key fraud risks unique to its own organization, depending on the nature of the industry, geography, vendors, customers, suppliers, and more. The risk assessment should also reflect COVID-19-related risks.

**2 Revisit Internal Controls:** Once the risk assessment is completed, internal controls must be analyzed to ensure that all risks are addressed with a corresponding control. Given the current public health crisis and resulting economic downturn, it is prudent to revisit:

- **Policies & Control Environment:**

This may include establishing or refining requirements for the documentation of journal entries, monthly analytical procedures, and management review and approval processes.

- **Segregation of Duties:** It is particularly important to revisit the organization structure and assignment of responsibilities following restructuring and/or layoffs.

### **3 Reassess Compensation Structures:**

Policies and posters do not determine or drive culture, rather compensation drives behaviors. Consider the metrics by which employees are compensated and how this could create incentive for fraudulent acts such as sales volume rigging or market manipulation. With a volatile stock market and/or unhealthy economy as the backdrop, even "business as usual" targets may be difficult to achieve. This will increase pressure on employees to meet valuation or revenue goals and also reach milestones for their personal compensation. For example, determine whether it makes sense to measure the salesforce by cash received from customers instead of sales. Similarly, if management incentives are based upon stock price targets, consider an alternate metric such as generating free cash flow.

### **4 Seek Independent Assurance of Internal Controls:**

While internal audit teams and compliance professionals can be invaluable in mapping risks to internal controls, independent third parties are best-positioned to assess controls' operating effectiveness and may also be helpful in uncovering financial statement fraud.

For example, post-incident, compliance consultants can apply data analytics to drill down on the original control gap that allowed the misconduct to take place, and then ensure sufficient remediation through controls enhancements and testing.

Before misconduct comes to light, a data analytics model could be used to programmatically benchmark, calculate and evaluate KPIs. A data-driven assessment will help reveal the high-risk areas to consider for pre-incident monitoring, which is an important step in detecting potential misconduct. The compliance department may also consider using targeted predictive analysis as part of its monitoring program to identifying potentially problematic transactions, at or near real-time. Doing so may uncover fraudulent activity before it can materially impact financial statements.

**5 Evaluate Training and Tone From the Top:** It is essential that management sets the standard for ethical conduct and should visibly and demonstrably reinforce a culture of ethics and compliance. When paired with regular trainings, the result is an effective tool against employee misconduct, including financial fraud.

**6 Understand the Role of the Audit Committee :** The Audit Committee has a critical role to play in the prevention of financial statement fraud. A study that reviewed corporate governance of companies and any financial statement fraud between 2001-2011, capturing the 2009 recession, found that the existence of an Audit Committee did in fact have a positive effect on the mitigation of financial statement fraud.<sup>6</sup> Above all, the Audit Committee is ultimately

responsible for the financial statements and the figures that the company publishes. It is crucial that the Audit Committee understands and acts on this responsibility, by facilitating discussions and walkthroughs with management, internal audit and compliance, and assisted by external advisors.

## Overcoming Uncertainty

As required by PCAOB Standard AS2401, a public company's external auditors will perform procedures to assess the risk of fraud within the financial statement and obtain assurance that no material misstatements have been made.<sup>7</sup> However, the final responsibility and oversight remains with management to ensure that sound financial and accounting policies are implemented and abided by.<sup>8</sup> Therefore, it is crucial that management be informed of the heightened risks specific and unique to the company during any crisis and implement additional controls to mitigate any risk of fraud in financial statements. Management must keep in mind that they risk being held personally liable for any allegations of financial statement fraud, regardless of knowledge of the incident or not.<sup>9</sup>

While it is impossible to determine how quickly the economy will recover following the pandemic, it is imperative that companies act on the understanding of the financial statement risks posed as a result of the changed business environment. Although current economic projections suggest that the risk of financial fraud is certain to be heightened, companies can successfully guard themselves from this risk by designing and following proper internal control procedures.

- 1 <https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020>
- 2 [https://www.acfe.com/uploadedFiles/ACFE\\_Website/Content/documents/occupational-fraud.pdf](https://www.acfe.com/uploadedFiles/ACFE_Website/Content/documents/occupational-fraud.pdf)
- 3 <https://www.sec.gov/litigation/complaints/2018/comp-pr2018-221-salix.pdf>
- 4 <https://www.sec.gov/litigation/admin/2020/34-88257.pdf>
- 5 <https://www.ft.com/content/1e753e2b-f576-4f32-aa19-d240be26e773>
- 6 <http://www.iacmaster.it/iacgconference2012/wp-content/uploads/2012/04/D-Onza.pdf>
- 7 <https://pcaobus.org/Standards/Auditing/Pages/AS2401.aspx>
- 8 <https://pcaobus.org/Standards/Auditing/Pages/AS1001.aspx>
- 9 SOX 2002: [https://pcaobus.org/About/History/Documents/PDFs/Sarbanes\\_Oxley\\_Act\\_of\\_2002.pdf](https://pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf)

## About the Authors

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