



UNIT-1

Introduction to Forensic Accounting

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Identify Fraud and types of Fraud
- ✓ Discuss the history of Fraud Auditing and Forensic Accounting
- ✓ Discuss different types of investigations and investigation planning

Unit 1

Introduction to Forensic Accounting

Introduction

Forensic accounting is a rapidly growing area of accounting that is used as a tool to prevent and combat financial frauds and white-collar criminal activities. George A. Manning, in his book *Financial Investigation and Financial Accounting*, describes forensic accounting as a way of gathering and presenting financial information in a format that can be used in a court of law in the prosecution of economic crimes. It integrates accounting, auditing and investigative skills to detect fraud and prevent fraudulent accounting practices in the future.

Forensic accounting analyzes financial statements in order to prove or disprove financial fraud and serves as evidence of fraud (or the absence of it) in a court of law. Therefore, it would be fair to say that forensic accounting emerged as a legal tool to detect, investigate and prevent bank fraud, cyber fraud, stock market fraud etc. When a client makes an allegation of financial misconduct, forensic accounting serves the purpose of investigating whether a fraud has actually taken place or not, by identifying the people involved in the entire matter and determining the financial magnitude of the alleged fraud. Then, the findings of this investigation are presented to the client and are sometimes used as evidence in court.

While the primary purpose of forensic accounting is to determine financial fraud, it might also be used in non-fraud-related matters such as settling monetary disputes in the event of the liquidation of a business, settling finances related to matrimonial disputes, and settling insurance claims.

Accountants specializing in forensic techniques use auditing tools to determine the length of time for which the fraud was committed and the way in which it was conducted and concealed by those who committed it. Forensic accountants also gather evidence to prove the following relevant matters in the event of the case going to court:

- The motive behind the fraud
- The involvement of other suspects in committing the fraud
- Physical or documentary evidence of fraud
- Any remarks or comments made by the suspect at the time of arrest or during interviews
- Any attempt to tamper with and destroy evidence.

Brief History of Fraud and the Antifraud Profession

The emergence of forensic accounting can be traced back in history to the time when an Egyptian Pharaoh appointed a person to keep watch over the kingdom's gold, grain and other assets to ensure that there was no fraud in the treasury. This person was essentially the first forensic accountant in history.

As businesses grew larger, fraud became more common. The South Sea Bubble is considered one of the first corporate frauds. The South Sea Company was a joint stock company established in 1711 in Great Britain in order to conduct trade with Spanish South America. The company was unable to make any profits due to the fact that Spain and Great Britain were embroiled in the War of Spanish Succession and no trade was taking place. The company had bought government bonds worth £10 million and had to borrow an additional £2 million due to lack of profits. Tension between England and Spain led to the capture of South Sea Company ships by Spain in 1718.

In 1719, the South Sea Company offered to take over all of the British government's debt, which was over £30 million. The company's plan was to use its stock at 5% in exchange for government bonds lasting until 1727. Parliament approved this scheme, which resulted in the South Sea Company's stock price rising from £128 in January 1720 to £550 by the end of May in the same year. Demand for the company's stock increased rapidly due to speculation and rumors of an increase in trade between Britain and Spain. Domestic as well as Dutch investment in the company led to further increases in stock.

Other joint stock companies then joined the market and took the opportunity to make profits by spreading fraudulent claims about foreign ventures, a phenomenon nicknamed the "Bubble". In 1720, Bubble Act was passed, requiring all joint stock companies to possess a Royal Charter. The South Sea Company, which had a Royal Charter, saw its shares soar to a price of £1,000 by early August. Some of the company's directors initiated a sell-off, selling the company's shares to cash in on high profits. The massive selling of shares led to a decrease in stock price to £150 by the end of September. All efforts made by the company to stabilize its stock price were in vain and the South Sea Bubble burst.

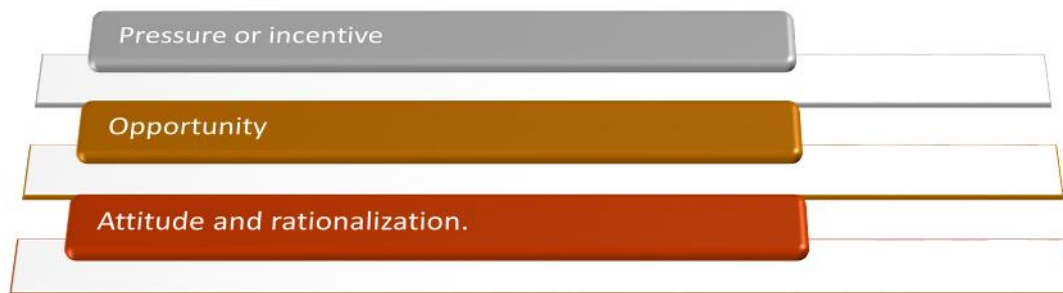
Many aristocrats who had invested in the company were outraged and demanded that Parliament investigate the matter. This was the first time in history that an external auditor had been hired to examine the accounting records of a company. Charles Snell, the auditor who examined the accounting books of the South Sea Company, revealed corruption and fraudulent practices among the directors of the company and the people who supported these practices in parliament. Some of the key people unveiled in this investigation had already fled, while others had their accounts examined and their properties confiscated.

It was in the aftermath of the South Sea Bubble fraud that Chartered Accountants of England and Certified Public Accountants were introduced.

What Is Fraud?

According to the Association of Certified Fraud Examiners (ACFE), occupational fraud is **“the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”**

The origin of fraud lies in greed and the opportunity for deception. It has severely negative repercussions on the economy, society, organizations and individuals. Therefore, fraud investigators’ job is to look out for symptoms of fraud and prevent its future occurrence. While fraud includes deception schemes, forgery, falsification of data and lying, white-collar crime involves the manipulation of accounts, embezzlement of money, and bribery etc. Therefore, the two are closely linked, with the intention to deceive at the core. The so-called fraud triangle involves three conditions that are likely to be present when fraud occurs:



The Fraud Triangle

All three components must be present at the same time for someone to commit fraud

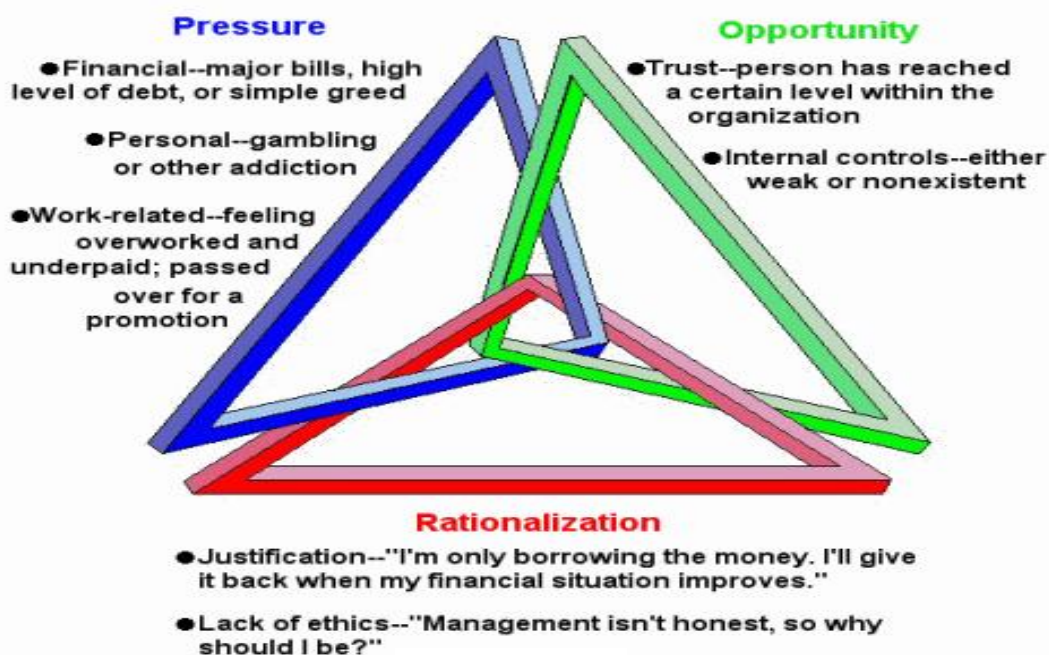


Fig 1.1

Types of Investigation

Fraud can be categorized into three main groups in order to determine the kind of investigation that is required. These three groups are corruption, asset misappropriation and financial statement fraud.



1. Corruption: Corruption is involved in one third of all instances of fraud. It can be further categorized into three types: bribery, conflict of interest and extortion.

- I. Bribery can be defined as the offering of money, or other valuable gifts, to influence a situation in one's favor.
- II. Conflict of interest occurs when a person exerts his/her influence to achieve undisclosed personal benefits, which may not necessarily be of a monetary nature, while affecting the organization. For example, a manager might approve the personal expenses of an employee who is also a close friend even though the organization should not be paying for those expenses.
- III. Extortion is demanding money, as opposed to offering it as a bribe, in order to achieve a desired outcome.

2. Asset misappropriation: This is one of the most common frauds and can take different forms, such as cash theft, fraudulent disbursements, misappropriation of inventory, misuse of assets etc.

- a. Cash theft is the stealing of cash from the company.
- b. The use of company funds to make fraudulent payments is called fraudulent disbursements. These include fake billing schemes (payments to fictitious suppliers), fake payroll schemes (payments made to fictitious employees) etc.
- c. Theft of a company's inventory is called inventory fraud.
- d. Use of a company's assets by its employees for their personal benefit is misuse of assets.

3. Financial statement fraud: This is the fraudulent reporting of finances that results in material misstatements in the company's financial records. It includes the deliberate omission of financial transactions, falsification of accounting records, omission of disclosures from financial statements, or the misapplication of financial reporting standards. The intention behind the manipulation of financial statements is to conceal the company's liabilities in order to give the impression of financial strength.

Conducting an Investigation

Conducting a forensic investigation is very similar to undertaking auditing practices, with a few additional considerations. The following are the stages of a typical forensic investigation:



Accepting the Investigation

The first stage of investigation is to determine whether the investigating team has the required experience and skills to undertake the job. Forensic accounting is a specialist field; therefore, accountants need to be well acquainted with investigation techniques and legal requirements. They should also be trained in handling evidence and keeping it in safe custody.

Other issues that must be considered before accepting an investigation include ensuring that ethical dilemmas are avoided. For example, it would not be objective to investigate an audit client. In other words, the investigating firm will be vulnerable to bias if it is investigating the same company that it audits.

Forensic investigators often charge a high fee, bearing in mind the expertise required for the job and the involvement of high-level officials of the company under investigation.

Planning the Investigation

The next stage in the investigation process is the careful planning of the work. The investigating team must determine the objectives of their assignment. These include the following:

- To identify the type of fraud that has been committed, the period of time for which it has been committed, and the way in which it has been concealed.
- To reveal the people involved in fraud.
- To determine the financial loss incurred by the organization as a result of the fraud.
- To gather evidence of fraud to present in court.
- To suggest ways of preventing the future occurrence of fraud.

The investigating team should be trained in the best evidence-gathering techniques, including computer-assisted audit techniques (CAAT).

Gathering Evidence

The investigating team must be very careful while gathering evidence and should ensure that the proper chain of custody is observed. If the evidence proves to be inconclusive and insufficient, or if the chain of custody is not followed, the evidence may be challenged in court and even deemed inadmissible. The team must be vigilant in safeguarding the evidence against attempts by suspects to destroy it. Various evidence-gathering techniques include:

- Identifying gaps in the client's internal controls that allowed the fraud to occur.
- Comparing trends over time to draw comparisons between different segments of the business with the help of analytical procedures.
- Identifying the time and location of computer data alterations with the help of CAAT, carrying out discussions and interviews with the client's employees.
- Reconciling cash accounts and reviewing documentation.

The whole exercise of gathering evidence and protecting it leads to the ultimate goal of obtaining a confession of fraud by the people who are allegedly involved in it. Interviewing suspects to obtain this confession is one of the key parts of gathering evidence, and the investigators must refrain from direct confrontations with the alleged perpetrators of fraud unless they have sufficient evidence to prove it.

Reporting

By the end of a fraud investigation, the client will expect a full report summarizing the evidence obtained, the extent of the losses incurred, the company's control mechanisms that were broken down by the perpetrators to commit fraud, the manner in which fraud was conducted, etc. The report may also contain recommendations and suggestions to improve internal controls for fraud prevention.

Court Proceedings

The whole investigation usually leads to a court case in which the evidence gathered during the investigation will be presented to the court. The investigation team members may also be called before the court to explain how they have managed to identify the perpetrators of fraud. Therefore, the investigators must be able to explain the evidence they have gathered professionally, in a language that is comprehensible to non-accounting people, and to defend their conclusions.

Forensic Accountants, Fraud Auditors and Financial Auditors

Forensic Accountants

Forensic accountants are trained in carrying out investigations, providing solutions to disputed accounting problems, formulating expert reports, gathering evidence and presenting it in court, and making court appearances as witnesses. A forensic accountant is not just an accounting expert; he/she is also well versed in legal matters and is able to provide assistance to lawyers.

Forensic accountants may specialize further in areas such as insurance claims, fraud, royalty claims, personal injury claims etc. Many large and medium-sized accounting firms have forensic accounting departments to assist them in fraud inquiries and other related matters.

Fraud Auditors

One area of forensic accounting is fraud accounting. It deals with criminal activities restricted to fraud, as opposed to forensic accounting, a more general name for a financial investigation that leads to legal outcomes.

Financial Auditors

Financial auditing is a different concept from forensic accounting and fraud auditing. Financial auditing typically refers to the process of evaluating the compliance of financial information with regulatory standards, usually for public companies, by an external, independent entity.

Table 1.1 – Comparison of Forensic Accounting and Financial Auditing

<i>Items for analysis</i>	<i>Forensic Accounting</i>	<i>Auditing</i>
<i>Why, when and where the services take place</i>	Serves as a back-up to prove a fraud in the business in an apparently risk-prone environment	Continuous, certifying the state of the art of a business and complying with the efficient market theory
<i>Scope of the job</i>	Presents analytical accounting and financial information to support legal and administrative decisions	Opines on the accounting statements of business entities considering all criteria used in their preparation
<i>Details of tasks performed</i>	Detailed planning of task aimed at documenting deterministic and calculative analysis.	Sampled and/or probabilistic procedures to serve as a basis for concluding the financial statement.
<i>Reporting</i>	Investigation or expert reports	Financial statements, management letters or auditors' report.

Required Knowledge, Skills, and Abilities for Forensic Accountants

Forensic accountants require skills and expertise that are very different from those possessed by traditional auditors and accountants. The following attributes are the essential components of a forensic accountant's skill set:

Ability to Identify Fraud with Minimal Initial Information

The forensic accountant often has to work with very limited information and has to rely on probable theories. He/she begins by identifying the possible fraud scheme, the possible manner in which fraud was carried out, and the procedures that might prove or disprove alleged fraud.

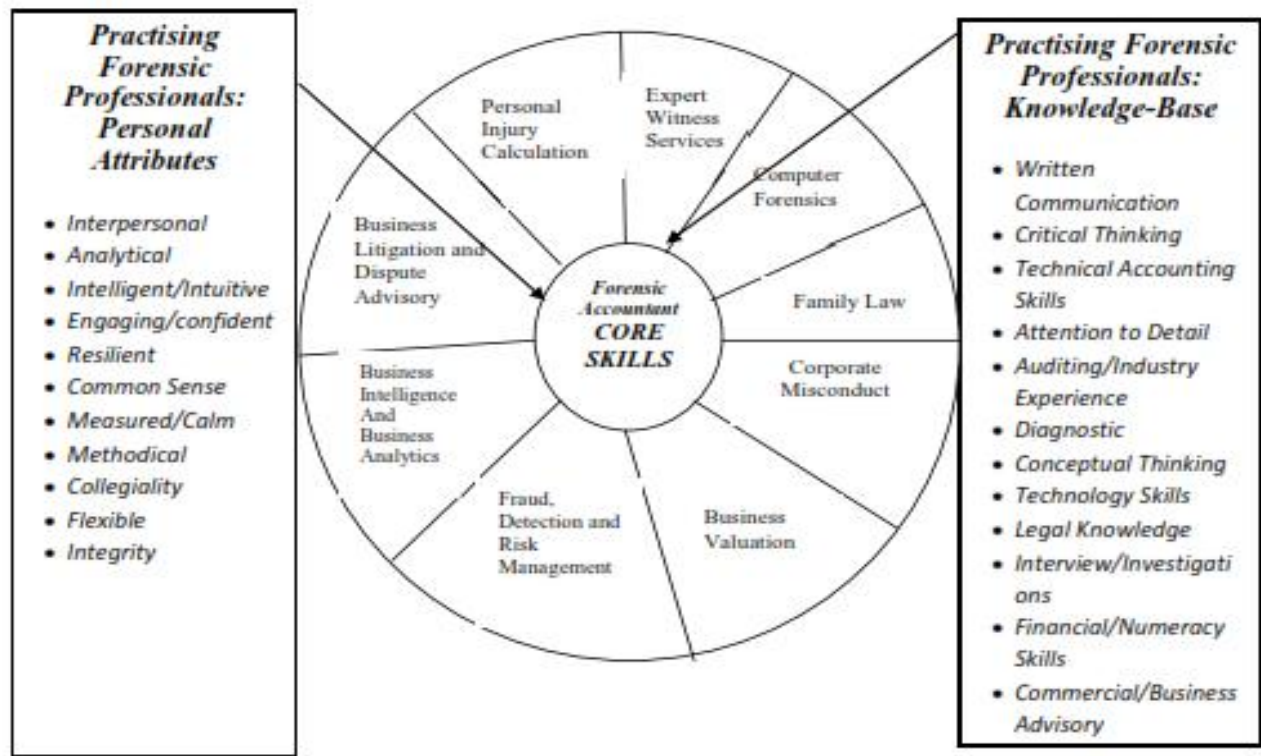


Fig 1.2

Interviewing Skills

Interviewing is one of the key elements of gathering information and evidence. The forensic accountant must have expertise in interviewing people who are important to his/her investigation. It is of the utmost importance that the forensic accountant obtains a confession in a way that is admissible in court.

Mindset

It is imperative that the forensic accountant develop a mindset enabling him/her to sense whether something is not right without actually knowing the nature of the anomaly. This attribute distinguishes a forensic accountant from an ordinary auditor who knows and abides by all the rules but is unable to think like a fraudster. A forensic accountant should be sceptical and should always question the originality/legitimacy of transactions, testimony and other documentation.

The following is a list of mindset factors that a forensic accountant should consider in order to carry out his/her job effectively.

- I. Financial audit techniques are designed to report significant financial misstatements rather than to detect fraud specifically.
- II. Detection of fraud might be accidental or aided by a tip.
- III. Detection of fraud relies more on creative thinking and innovation than on scientific principles. Ultimately, the ability to detect fraud is dependent on a mixture of impulse and science.
- IV. A successful fraud investigation is a result of intelligence, persistence, determination and self-confidence.
- V. Forensic accountants and fraud auditors should possess logic, problem-solving tactics and detective skills.

Knowledge of Evidence

A forensic accountant must be an expert in evidence-gathering techniques and be aware from the beginning of the investigation that such evidence may be used in a court of law. He/she must make every possible effort to ensure that the evidence is valid and admissible in court. Moreover, the forensic accountant must be able to identify evidence when he/she sees it and must understand the concept of “best” and “primary” evidence.

Presentation of Findings

A forensic accountant may present his/her findings in either a written or an oral format. The presentation may also be accompanied by demonstrative aids. It is imperative that the presentation be comprehensible to a layperson. A forensic accountant should acknowledge the fact that accounting or financial information is not easily comprehensible to the average person lacking an accounting background; the forensic accountant should thus strive to convey his/her findings in the most comprehensible manner. Forensic accountants should also be aware of and prepared for the possibility of having to present their findings from the witness box.

Knowledge of Investigative Techniques

A thorough understanding of the intricacies of Generally Accepted Accounting Principles (GAAP), financial statement disclosure, internal control mechanisms, etc. is vital in order to carry out an efficient investigation. The forensic accountant should focus on obtaining additional information and evidence in order to support or refute allegations of fraud after the main issues and objectives of the investigation have been identified.

Investigative Skills

Investigative skills are an essential element of a forensic accountant's skill-set. He/she will usually need to apply these skills at a time in the investigation when evidence is being developed around the motive and opportunity for the crime and the benefit derived from it. Forensic accountants must also remain objective and give the benefit of the doubt where it is due. The method of operation and economic risk are also factors that need to be considered. Forensic accountants should understand and clarify any assumptions they have made during the course of the investigation to provide sufficient support during litigation. They should assess and estimate future losses while recognizing the limitations of their expertise.

Investigative Mentality

In addition to accounting knowledge, forensic accountants must possess an investigative mindset that goes beyond accounting principles and regulations and allows them to think 'outside the box'. This mindset might be developed with the intent and determination to gather reliable forensic evidence. For this purpose, there are three fundamental principles of forensic accounting as follows:

Scope is not restricted as a Result Of Materiality

In the early stages of a fraud, financial transactions are usually simple and small, making it easier to prove in court the intent to deceive and commit fraud. However, as fraud progresses, the amount of money that is involved increases significantly and transactions become more complicated. This results in the evidence becoming buried beneath layers of financial information, making the forensic accountant's job more difficult.

Identification of Financial Issues

Initially, when forensic accountants are asked to conduct an investigation due to an allegation of fraud, a rumor, a statement of claim or an inquiry, they must rely on their judgment, experience and expertise to separate relevant financial information from irrelevant facts. Their decision must reflect business acumen and common sense. For instance, when the process of obtaining evidence is highly costly and time-consuming, for example, from a foreign jurisdiction, forensic accountants should first try to consider alternatives rather than following the obvious route to obtain records.

Interpretation of Financial Information

Any forensic accountant likely to be called to testify in court as an expert witness should be aware of and should have considered all possible alternative interpretations of the financial transactions in question. All transactions may have various interpretations and it is up to the forensic accountant to remain as objective as possible and choose the one that is most consistent with business reality and common sense. For this purpose, it is also crucial to examine all available information thoroughly and in depth.

Further Reading:

- ✓ *Manning, G. A. (2005) Financial Investigation and Forensic Accounting, 2nd ed.*
- ✓ *Golden, T.W., Skalak, S., Clayton, M. (2006) A Guide to Forensic Accounting Investigation*
- ✓ *Singleton, T., et al. (2006) Fraud Auditing and Forensic Accounting*
- ✓ *Silverstone, H., Sheetz, M. (2006) Forensic Accounting and Fraud Investigation for Non-Experts, 2nd ed.*