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Forensic Accounting

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ABSTRACT

Forensic Accounting is a special field of accounting that utilizes accounting, auditing, and investigative skills to identify and resolve legal issues. Forensic Accounting involves looking beyond the numbers, it is more than accounting work or detective work - it is a combination of the two. This paper will focus on the use of Forensic Accounting, the addition of Auditing Standards (SAS) No. 99's 42 red flags, and the ten Statements on Auditing Standards (SAS) Nos. 102-111 and how they work together to detect fraudulent financial statements.

INTRODUCTION

The first known use of forensic accounting was in the conviction of Al Cappone for tax evasion in October of 1931. "Forensic," according to Webster's Dictionary, is defined as "belonging to, used in or suitable to courts of judicature or to public discussion and debate," or more simply, "the information uncovered is capable of being used in court." Forensic Accounting is the application of accounting knowledge and investigative skills to identify and resolve legal issues. It is the science of using accounting as a tool to identify and develop proof of money flow (Houck 2006).

Forensic Accountants work anywhere investigative accounting is needed. This ranges from private corporations or firms that help specific companies deal with suspected (or known) fraud and embezzlement, to government organizations like police departments, the FBI or the CIA. Forensic accountants also frequently work for public accounting firms, banks, the IRS, insurance companies and law firms.

FORENSIC ACCOUNTING

Forensic accounting is the practice of utilizing accounting, auditing, and investigative skills to assist in legal matters. It encompasses two main areas – litigation support and investigation. Litigation support represents the factual presentation of economic issues related to existing or pending litigation. In this capacity, the forensic accounting professional quantifies damages sustained

by parties involved in legal disputes and can assist in resolving disputes, even before they reach the courtroom. If a dispute reaches the courtroom, the forensic accountant may testify as an expert witness.

Investigation is the act of determining whether criminal matters such as employee theft, securities fraud (including falsification of financial statements), identity theft, and insurance fraud have occurred. As part of the forensic accountant's work, he or she may recommend actions that can be taken to minimize future risk of loss. Investigation may also occur in civil matters. For example, the forensic accountant may search for hidden assets in divorce cases.

Since all professional accountants operate within a commercial legal environment, all professional accountants are, in a sense, forensic accountants. What distinguishes forensic accounting, however, are the engagements. That is, when a professional accountant accepts an engagement where they anticipate that their finding or analysis may be subject to adversarial or judicial scrutiny or administrative review, the professional accountant seeks a level of evidentiary detail and analytical precision which will be sustainable within the legal framework of such scrutiny or review. This approach is based on no more than the realistic appreciation that, while there is some evolutionary dialogue, in the end, the courts or appropriate administrative bodies, are the ultimate arbiters of what accounting facts are.

Forensic accounting is focused, therefore, upon both the evidence of economic transactions and reporting as contained within an accounting system, and the legal framework which allows such evidence to be suitable to the purpose of establishing accountability and/or valuation. Engagements are wide-ranging, and include transaction reconstruction and measurement; bankruptcy, matrimonial divorce, and probate asset identification and valuation; falsifications and manipulations of accounts or inventories or in the presentation thereof; and accountability within the statutory audit and other environments; among many others. Increasingly, as various parties perceive the value of such evidence, grounded as it is in "accounting facts," forensic accountants are called upon to play important preemptive roles (as of right, without cause), offering independent assurance in such diverse areas as audit committee advisory services, merger and underwriting due diligence, investment analyst research, and enterprise risk management.

The Deloitte Financial Advisory Services recently formed the Deloitte Forensic Center. The goal of the DFC is to be a "think tank" aimed at exploring new approaches for mitigating the costs, risk and effects of fraud, corruption and other issues facing the global business community. There will be a particular focus placed on the use of technology as a means of providing solutions to fraud and corruption detection, mitigation and prevention (CCH, Inc. 2007).

THE RISK ASSESSMENT STANDARDS AND RED FLAGS

Statement of Auditing Standards (SAS) No.99: Consideration of Fraud in a Financial Statement Audit (introduced in 2002) raised the expectations of auditors in detecting fraud. It calls on them to take on more responsibility and to "think like both a thief and a detective and be constantly looking for the weak links in the accounting system and among the people who staff it." The standard supersedes the American Institute of Certified Public Accountants' SAS No. 53 and SAS No. 82, which first identified red flags of possible fraudulent activity and required external auditors to detect fraud that may result in a material misstatement of the financial statements. Published in 1988, SAS No. 53 described 14 red flags, and SAS No. 82 added 25 red flags in 1997. SAS No. 99 increased the number of red flags to 42, extensively revised the existing indicators, and required auditors to consider the risk of a possible material misstatement due to fraud (Moyes 2005). SAS No. 99 now requires that CPAs serving as external auditors use these 42 red flags in financial statement audits to detect any fraudulent reporting. If any of these red flags detect fraud and are ignored, the auditors who failed to recognize the fraudulent activity will most likely be held negligent, as was Arthur Andersen in the Enron scandal (Moyes 2008).

The American Institute of CPAs also issued 10 new Statements on Auditing Standards (SAS Nos. 102-111). The titles of each standard, and their corresponding numbers, are shown in Exhibit 1. One of the standards addresses audit documentation and another discusses professional requirements. The remaining eight are conceptually related and are known as the Risk Assessment Standards. These Standards were effective for audits of financial statements for periods beginning on or after December 15, 2006. Forensic Accountants should be familiar with the new standards. Although they were issued for external auditors, the requirements in the standards, particularly the eight Risk Assessment Standards, are extremely useful to Forensic Accountants as well. They should understand the requirements in the standards and how the new mandates affect and expand the work performed by the external auditors in the examination of the financial statements. The enhanced work performed by the external auditors in areas that are especially prone to misstatements may reveal clues that Forensic Accountants can use to help them more efficiently and effectively plan their own work.

Table 1: New SAS Numbers and Titles

SAS No.	Title
102	Defining Professional Requirements in Statements on Auditing Standards
103	Audit Documentation
104	Amendment to Statement on Auditing Standards No. 1 Codification of Auditing Standards and Procedures
105	Amendment to Statement on Auditing Standards No. 95 Generally Accepted Auditing Standards
106	Audit Evidence
107	Audit Risk and Materiality in Conducting an Audit
108	Planning and Supervising
109	Understanding the Entity & Its Environment and Assessing the Risk of Material Misstatement
110	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

SAS No. 99 classifies the 42 red flags into three categories: 12 attitude or rationalization (AR) red flags, 14 opportunity (OP) red flags and 16 incentive or pressure (IP) red flags. The 42 red flags stated in SAS No. 99 originated from the fraud-triangle concept that involves the interaction of three factors: incentive, opportunity, and attitude. If fraud is thought of metaphorically like a fire, it makes sense that it is better to prevent a fire than to put it out. The incentive/pressure factor is the existence of "need or greed" that can trigger someone to commit fraud, such as pressure to pay for a lifestyle. This can be viewed as the source of heat for the fire. The opportunity factor is the fuel that can get the fire going. Even if someone has motive, they must have opportunity before they can commit fraud. The attitude or rationalization factor can be viewed as the oxygen that keeps the fire burning. Human nature dictates that people will not commit an act unless they can rationalize it to themselves. Therefore, corporate and/or management's attitude toward fraud is a major factor in their employees attitude about fraud.

Because SAS No. 99 requires CPAs as external auditors to use the 42 red flags to detect any fraudulent financial reporting activity, there have been several surveys and studies conducted on the red flags to rank their effectiveness and determine which are best suited for fraud audits. Some important questions: How effective is each of the 42 red flags in detecting the fraudulent activity and should auditors rely more heavily on certain flags and ignore others, or are they equally weighted?

In the study conducted by Moyes (2008), they found that most CPAs

consistently felt that opportunity and attitude/rationalization red flags were much more effective indicators of possible fraud than incentives/pressure red flags. Incentive and pressure factors were viewed as less effective in determining fraud in this study as well as several other studies conducted over the past years. The respondents of this survey tended to have extensive experience using red flags for fraud detection and 81% had completed continuing education courses on fraud detection and red flags.

OVERVIEW OF A FORENSIC FINANCIAL INVESTIGATION

Financial investigations are accounting inquiries aimed at ascertaining whether a company's financial results were misstated or whether one or more employees received an improper financial benefit from the company. Occasionally, these investigations rise to the level of being a "forensic financial investigation." The word "forensic" simply means that the information uncovered is capable of being used in court. There are a variety of possible triggers for a forensic investigation, but most fall into the following categories:

1. Regulatory Inquiries –When the SEC challenges a company's financial reporting or disclosure practices.
2. Shareholder Actions – When one or a group of shareholders file suit, demanding that the corporation take action against specified corporate officials who have been accused of fraudulent reporting or "self-dealing transactions".
3. Internal Audits – When a company's internal audit department raises issues that may trigger a financial investigation.
4. Independent Audits – When an external auditor recognizes "fraud indicators" that may indicate fraudulent financial reporting.

The investigation is usually conducted by a team of professionals, including lawyers and accountants. These investigations are typically begun because someone raises questions regarding the propriety of a transaction or group of transactions. There are five key areas in which an outside team can be extremely valuable during a financial investigation:

1. Investigations – Discovering and analyzing the most sophisticated circumvention of internal controls, unwinding complicated transactions, and reconstructing events.
2. Forensic Accounting – Identifying, collecting, analyzing, and interpreting financial and accounting data with methodologies that produce independent thoughts, reports and expert individual opinions that will stand up to the toughest scrutiny.

3. Electronic Discovery – Dissecting complicated transactions and exposing vital evidence – a crucial capability since more than half of business documents are stored in electronic form.
4. Compliance – Working closely with both in-house and outside counsel to provide advice on Sarbanes-Oxley issues, corporate governance matters and a variety of compliance requirements involving restatements and disclosures.
5. Litigation Consulting – Assistance in developing solutions to resolve identified issues and present findings to the SEC, PCAOB, courts and other venues (Hochberg 2006).

KEYS TO FIGHTING FRAUD

There are three phases to developing an effective anti-fraud program: assess, improve, and monitor. All organizations can benefit from assessing their fraud risks and developing a strong anti-fraud program that:

- Provides tangible evidence of a culture of integrity.
- Helps prevent fraud and facilitates early diction.
- Improves fraud detection, monitoring and training.
- Limits unpleasant surprises that can affect stock price
- Addresses concerns of the external auditor and board of directors.
- Limits potential class-action lawsuits.

One important element in fraud prevention is an anonymous and multi-lingual hotline. Studies have shown that organizations with these hotlines suffer much less in fraud losses than organizations that do not. Table 2 shows that Notification by Employees and Internal Controls were both used 19% of the time in detecting fraud cases. An effective anti-fraud program can improve stakeholder confidence in the organization – which in turn enhances its ability to attract investors, maintain customers, and lower financing costs. A fraud risk assessment process should be ongoing, dynamic, and reflect the organization's current business conditions.

Table 2: Methods Used to Discover Fraud Cases

Methods	Detection Rates (%)
Internal Controls	19
Notification by Employees	19
Management Investigations	12
Employee Investigations	11
Notification by Customer	9
Accident	7
Anonymous Letter or Call	6
Internal Auditor Review	5
Third-Party Investigation	4
Notification by Supplier	3
Notification by Bank	2
Other	3

Source: KPMG Fraud Survey 2004

CONCLUSION

The addition of SAS No. 99's 42 red flags and the 10 New Auditing Standards (SAS Nos. 102-111) have not only given auditors more tools in detecting fraudulent financial statements, but they have also increased the expectations of the auditors to detect fraudulent financial reporting. These Standards, along with the Sarbanes-Oxley Act of 2002, make it much more difficult for public corporations to mislead the public, including investors and employees, about their financial position. The addition of these standards was a very positive step for the Auditing Standards Board in the aftermath of a number of major corporate and accounting scandals including Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom. These scandals, which cost investors billions of dollars when the share prices of the affected companies collapsed, shook public confidence in the nation's securities markets. The standards should ensure that this type of scandal does not happen again.

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