

A Study of Forensic Accounting a useful tool to combat Fraud

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ABSTRACT

Greed and arrogance - the main roots of Fraud, are human nature. If we look through the financial transaction fabric, it transpires that, over the years, Fraud or deception has become an industry, not just for the group of fraudsters - academics study it, investigators investigate it, lawyers litigate on it and conference-goers debate it. In business, we must recognize fraud as a permanent risk which we must take action to prevent and manage.

Fraud is theft which hits an enterprise in the pocket having direct impact on the bottom line and in turn the economy. The extent of fraud and white-collar crime resulted in the formation of various specialized units in law-enforcement agencies and also in a major demand for accountants in the fields of forensic accounting.

More appropriately, crimes can only be proved with forensic reports and testimony by expert investigators. Experience shows that instead of preventing the fraud, industry is built on managing the consequences of fraud. Though, in practice, professional investigators offer services to detect the cause and creators of the crime, in recent past, endeavors towards preventing fraudulent practices are growing globally by creating a culture and environment and developing structured syllabus and training towards this direction. According to a report released by Nedcor on South Africa in 1994/1995, a large part of the amount of fraud could be attributed to white-collar crime.

1. What is Forensic Accounting

The word forensic is derived from the Latin word forensic, meaning thereby belonging to the forum, which was the site for public debate in ancient Rome. Forensic relates to the use of science or technology in the investigation and establishment of facts or evidence on legal platform. Hence, forensic testimony or forensic medicine is used to help the legal system in resolution of disputes or issues, including assistance at a trial. The integration of auditing with accounting and investigative skills brings the specialty known as forensic accounting. Forensic Accounting believes in analysis of evidences. This branch of study and operation with specialty practice area of accounting describes engagements of professional investigating agencies which result from real or anticipated litigation arising from financial or accounting crime or fraud. The word forensic accounting can be split into two parts, viz., (a) Forensic—which means relating to, or normally used in courts of law or public debate or some sort of argument and (b) Accounting—the language that provides information about the financial position of an entity.

With the growth over time, the business world has become more complex. Need for Financial reporting have emerged as a top priority and interest in determining true financial status has become even more paramount. The 1970s witnessed massive problems of corporate financial disclosure like in companies—Lockheed and Perm Central, created a furor that blamed financial accounting irregularities on cozy relationships between corporate top management and the independent auditors.

The decade of 1980 showed us problems of high magnitude in the corporate world mainly in the US covering savings and

loan industry, E.F. Hutton, and Drexel Burnham Lambert, Inc. Content and timing of the financial reporting disclosure requirement in 1990s put enormous pressure on the companies. Besides, the spread and growth of internet based media function, board room discussion has come to the viewing public but it is well accepted that the gangsters are not just afraid of the awareness of the general public and corporate leaders about their strategic movements in the recent times and they are improving their techniques of fraud at a much higher pace.

2. Financial Auditing, Fraud Auditing and Forensic Accounting

The term Forensic Accounting is commonly coined with the use of accounting principles and investigating techniques to ferret out fraud and theft. This subject often testifies in legal parlance and functions as a useful instrument in building legal cases. Forensic Accounting also encompasses providing services in major legal areas namely, damages, antitrust, accounting, valuation, general consulting and analysis.

Financial Auditing: The auditor's role is to opine on the fairness and compliance with the requirement of Accounting principles, standards, legal and other relevant angles and the action is based on historical data. The financial auditors are responsible to the clients and users of financial statements issued.

Fraud Auditing: In regulatory environment, Fraud auditing aims at assessing the likelihood of prevention and detection of fraud. It is desirable that they make recommendations to implement procedures to detect or prevent fraud. Fraud audits are mostly proactive in nature

and not to be confused with fraud investigations conducted generally by Forensic Accountants who are responsible to its employer or client.

Forensic Accounting : Forensic Accountants' objective is related to the specific issues defined by the client engaging them, such as calculate the loss, calculate the royalty, calculate the value of the pension plan, etc. by examining a trail of paperwork to substantiate the calculations needed to meet the specific goals of the engagement. The forensic accountant is not performing the attest function like the financial auditor. Basically the objective for hiring the forensic accountant is to use the accountant's views and findings to facilitate a settlement, claim, or jury award by reducing the financial component as an area of continuing debate. (Source: *Information obtained from 'A Guide to Forensic Accounting' by Jill A. Blumenfeld, Reprinted with permission, Faulkner & Gray 1992*).

3. Development of Forensic Accounting

Phase-1 The Evolution in the early age & appearance in 19th century

Forensic Accounting dates back to the ancient Egyptian scribes who accounted for all of the Pharaoh's assets. They were well known as the "eyes and ears of the Pharaoh, the king". However, in 1817, Forensic Accounting had its first appearance on a day in court when an accountant was required to testify at a hearing of bankruptcy. It got larger appearance only in 1824, when a Scottish accountant advertised his expertise in legal accounting, but the term Forensic Accounting was yet to be coined and popularized.

Phase-2 Forensic Accounting & its role in catching gangsters - a saga of early 20th century

Development and first popularity of the subject, Forensic Accounting is mainly in Western part of the globe though, by the passage of time, it is getting more and more importance in fraud prevention and investigative actions in the modern corporate sky.

▪ *Forensic Accounting and the Al Capone Case in Us*

Conviction of the then mobster Al Capone in 1931 was successful only due to IRS and FBI used accounting for this purpose. The legal system could not arrest him until tax evasion case could be established by law enforcement by using accounting expertise. The agent Frank J. Wilson played a great role by establishing charges with finding proof of tax evasion against Al Capone, the mobster. Wilson could prove it with the evidence for a conviction by sifting through millions of financial documents!! As a result of the grand success in the case, the IRS produced an ad campaign - "Only an Accountant Could Catch Al Capone."

▪ *Forensic Accounting and Lindbergh Kidnapping*

The same Frank J. Wilson continued to influence the society with his forensic accounting work on the case of Kidnapping of

Lindbergh baby in 1932. He used the technique of tracking the serial number of the gold certificates used to disburse towards the kidnapper's ransom and was able to trace and identify the perpetrators in the case. The methodology he used in this case made him popular and Forensic Accounting function got widespread practice in tracking and prosecuting financial crime. Thereafter Wilson joined the Secret Service and created a laudable work by formulating educational program to fight counterfeit currency.

Phase 3 - Forensic Accounting - the present scenario - the O. J. Simpson trial

The credit of developing the term Forensic Account goes to Maurice E. Peloubet when, in 1946, he used this in his essay "Forensic Accounting: Its Place In Today's Economy". Though this term had proven its worth during the World War II, it got structured procedures during the 1980s. It was due to the major academic works published during this period. Forensic Accountants evaluated the value of assets of O.J. Simpson during the trial having the impact of the damages awarded in the civil suit. A pivotal role was played even after that by the Forensic Accounting in the corporate scandals of companies such as Enron, Tyco and Worldcom.

4. Establishment of Academic and Profession bodies

• The Western panorama

The American College of Forensic Examiners was formed in 1992 while the American Board of Forensic Accounts started in 1997. Publication of the Journal of Forensic Accounting, Auditing, Fraud and Taxation began in 2000. The famous Sarbanes-Oxley Act was established in 2002 with the Public Companies Accounting Oversight Board (PCAOB) with the responsibility of conducting investigations, developing auditing standards, and ensuring implementation of corporate compliance. It is because of the establishment of the Sarbanes-Oxley Act that continuing emphasis on forensic accounting was possible.

• The initiatives in Asian context

In recent past, global initiatives are growing to teach the technique of combating fraud by conducting various workshops and courses. One such initiative is undertaken by Asian School of Cyber Laws—it is one such initiative that teaches people about the frauds related to cyber world. Indian chapter of ACFE offers the course to cover the white-collared crimes. In India, India Forensic, an organization yet to be affiliated to any of the Universities, provides formal education about Forensic Accounting. Some of the initiatives in this direction are - Certified Forensic Accounting Program - CFAP, Certified Bank Forensic Accounting - CBF, Certified Anti-Money Laundering Expert - CAME.

5. The Indian Scene

Though, in 1946s, Maurice Peloubet coined the term Forensic Accounting, worldwide we recognize the great Sherlock Holmes to be the first Forensic Accountant. However no one can ignore the considerable contribution made by some

historic characters in India in this arena. During the ancient Mauryan Times, Kautilya was the first person to describe the famous forty ways of embezzlement in his famous book, Kautilya's Arthashastra. In a remarkable exercise carried out at the "Indiaforensic", Kautilya is brought back into the 21st century and have started the series of virtual conversations between him and the computer. Through the dialogue, it is revealed that almost all the major failures in USA Incorporates were the extended versions of what Kautilya said few thousand years before. Even there is hardly any change in their number. This virtual conversation between Kautilya and the computer of the present age is available in the Indian Forensic Accounting Manual. Birbal was another stalwart and great scholar in the time of King Akbar who used various tricks for investigating various types of crime. These work as the Litmus test to the Fraud examiners even of recent times. Birbal's stories are mostly applied by the Gem of Indian Fraud Examiners, Chetan Dalal, to the investigation of the frauds. Another one, the third scholar in the above field, is Tenaliram who emphasized on the techniques of investigations to detect the root of fraud and the perpetrators. Leaders like KPMG, E&Y have already taken commendable steps by organizing training and also have praiseworthy research work in this field.

6. Forensic Accountant- Prerequisites

The subject being still young and high tech involved in the present age when Cyber crimes are taking the lead in field of fraud, the Forensic accountant needs to be, firstly, a professionally qualified accountant like CA, CPA etc and then he must get trained in the techniques of forensic accounting under some recognized association to get acquainted and skilled in this specific arena. There are some existing organizations and besides them, leaders like KPMG, E&Y, PwC contributes substantially towards advancement of this branch of study. With qualifications, like auditors, a forensic accountant needs the intuitive skill also to get success in this highly skill driven profession. The goal is to have the best possible quality in the Forensic Accountant to combat the horror in the present days of terror fill world.

7. How Forensic Accountants work—the Fraud Triangle

The Forensic Accountants mainly rely on the Fraud Triangle consisting of three core concepts leading towards happening of fraud, namely, Incentive, Opportunity and Rationalization. Recent study suggests a fourth concept to convert the triangle to a diamond by adding: Capability. That means, in absence of any one of these four concepts, fraud generally cannot take place.

Forensic accountants in today's complex commercial world are being deployed to not only play the investigative role once the fraud appears but also act as the preventers of financial mischief by ongoing process of utilizing their skill and techniques in the operational level of the enterprise. This helps to nip the problem in the bud rather than spending time after the unwanted situation crops up (Source : *Introduction to Forensic Accounting, by Robert K. Minniti, CPA, CFE, Cr.FA, CFF, MBA*).

Flight of Forensic accounting with some major development of relevant laws in the world, particularly in the Western countries who are pioneers in the relevant fields

- 10,000 years ago -temple priests took inventory of village livestock
- 3,000 B.C—scribes recorded ruler's wealth
- 1200's Florentine merchants use double entry bookkeeping
- 1494 - Luca Paacioli publishes first book describing double entry accounting methodology
- 1772 - Josiah Wedgwood, Charles Darwin's grandfather, develops cost accounting
- 1856—In England, the audit of corporations became required
- 1887—American Association of Public Accountants (later becoming the AICPA) was formed
- 1902—American Congress calls for audit reports for large corporations
- 1913-Federal Reserve Board created 1913— Federal income tax law was passed 1914— Federal Trade Commission created
- By 1921 -All states had passed laws requiring exam for CPA certificate
- 1931 - Al Capone was indicted for income tax evasion—the first documented use of forensic accounting
- 1946—Maurice E. Peloubet coined the phrase "Forensic Accounting"
- 1982—The first forensic accounting book was written 2002— Sarbanes Oxley Act
- 2003—The AICPA's Litigation and Dispute

Resolution Services Subcommittee issued a report of its Fraud Task Force entitled "Incorporating Forensic Procedures in an Audit Environment."

(Source: *Introduction to Forensic Accounting, by Robert K. Minniti, CPA, CFE, Cr.FA, CFF, MBA*)

8. Conclusion

In the present day, corporate management is to ensure sustainable development through operation of a good corporate citizen and it is also required to act proactively in the area of efforts towards eradicating the Fraud nuisance too. Forensic accounting function has a great role to play in this regard as truly investigative minded professionals. Hence it is demanded to put experts like Forensic Accountants to assist the entities to combat fraudulent practices proactively, besides their investigative, function on historical crimes.

Besides, proper data storage and document control system backed by appropriate IT Support for need based trailing of chain of transaction to be ensured to support forensic accounting and forensic audit function to meet the challenges Of the present corporate world to convert the dream of Fraud-free corporate world into reality.