WHAT IS FORENSIC ACCOUNTING?

Forensic medicine is a science that deals with the relation of and application of medical facts to legal problems. Likewise, forensic accounting is a science that deals with the application of accounting facts gathered through auditing methods and procedures to legal problems. Forensic accounting is much different from financial auditing. The main purpose of an audit is to examine the financial statements of an entity in order to express an opinion on whether the financial statements show a true and fair view or whether the financial statements have been prepared in accordance with the applicable financial reporting framework.

An audit is not an investigation, and its main objective is not to uncover fraud. Audits are performed by independent accountants and are not conducted with a view to present the evidence in a judicial forum. In contrast, forensic accounting is the investigation of an allegation with the idea in mind that the forensic accountant will have to present the evidence in a judicial forum. Forensic accountants often employ specialists in other areas as part of a team to gather evidence.

In order to present the evidence in court, there must be absolute assurance. Thus testing and sampling methods are not employed as part of the evidence gathering procedures. The scope of the investigation is limited since it is determined by the client, but usually concerns issues relating to misappropriation of assets or fraudulent financial reporting. Forensic accounting thus is a specialty that is the integration of investigative, accounting and auditing skills.

The forensic accountant looks at documents in a critical manner in order to draw conclusions and to calculate values. They review financial and other data to identify irregular patterns and/or suspicious transactions. They understand the fraud risk areas and have extensive knowledge on fraud. Forensic accountants don't merely look at the numbers. They look behind the numbers.

One can further say that forensic accounting is a discipline consisting of two areas of specialization, namely, litigation support specialists and investigation or fraud investigators. Litigation support specialists concern themselves with business valuation, testimony as expert witnesses, future earnings' evaluation and income and expense analysis. On the other hand, fraud investigators apply their skills to investigate areas of alleged criminal misconduct in order to support or dispel damages. These fields overlap such that a forensic accountant will do litigation support work one month and perhaps act as a fraud investigators on another engagement.

Both forensic accounting and fraud investigating engagements could result in expert testimony by the forensic accountant. Thus the authors prefer to define forensic accounting in a more generic way. Forensic accounting is merely a discipline where an individual utilizes his/her expertise in auditing, accounting and investigative skills to assist in disputes involving financial issues and data and in those cases where there is suspicion or allegation of fraud.

The expertise of the forensic accountant may be used to support a plaintiff who is trying to establish a claim or to support a defendant in order to minimize the impact of a claim against him or her. Usually such investigations involve litigation. However, sometimes disputes are settled by negotiation. In either case, persuasive and authoritative evidence resulting from the financial and investigative skills of the forensic accountant is imperative.

The forensic accountant must be a good businessperson and be aware of statutory law, common law, and the laws of evidence and procedure. Usually the forensic accountant's findings are based on facts, not opinions. Facts can be investigated, and the forensic accountant can prepare a definitive report on the facts. Nevertheless, there are situations where the forensic accountant may rely on professional judgment and present findings using an opinion-type report.

The reports based on facts usually do not present problems in court cases as they are supported by underlying documentation. Opinion reports, on the other hand, are subjective in nature and require that the forensic accountant demonstrates competency and provides adequate logic for his or her opinion. Two points are often overlooked when one is involved in a case as a forensic accountant. Namely, (1) the other side usually employs a forensic accountant as well; and (2) the credibility of a forensic accountant is extremely important. Thus the forensic accountant must have a high degree of professional standards and ethics.

Are Forensic Accountants Necessary?

Business and criminal activities have become very complex such that lawyers and criminal investigators do not have the expertise necessary to discharge their responsibilities. This fact and the fact that there has been a marked increase in white-collar crime, marital and business disputes and other claims have created the need for a new industry called forensic accounting.

Although as previously stated, forensic accountants are not only involved with fraud issues, the reality of the arena of forensic accounting is that most of the work does involve fraud investigations. In the case of fraud, the work of a forensic accounting team is crucial, as the business may not survive due to the fraud. Good business people must realize that fraud is a permanent risk in any and all businesses. Thus company leaders must devise ways to prevent fraud rather than trying to manage the consequences of fraud.

Fraud has increased due to lack of government commitment, more sophisticated criminals, inefficiency of the judicial system, more complex technology, lack of adequate penalties and deterrence, and —old fashioned‖ greed and arrogance. Studies have shown that fraud will continue to increase. It is a well-known fact that most of the fraud results from employees, particularly high level employees. Other sources of fraud are customers, management, suppliers and service providers.

In addition, the majority of the fraud is discovered as a result of strong internal controls. Other methods of discovery include whistle blowers, customers, internal auditors, by accident, or formal investigation. In the past, detecting so-called white-collar crime was deemed to be an accounting function caught either by the internal or external auditors through their periodic audits. However, the auditors' role is not to detect fraud and very little fraud is actually discovered by auditors.

CONDUCTING AN INVESTIGATION

The process of conducting a forensic investigation is, in most cases, similar to the process of conducting an audit, but with some additional considerations. The various stages are briefly described below.

Accepting the investigation

The forensic accountant must initially consider whether their audit firm (or forensic accounting firm) has the necessary skills and experience to accept the work. Forensic investigations are specialist in nature, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Investigators must also have received training in interview and interrogation techniques, and in how to maintain the safe custody of evidence gathered.

Additional considerations include whether or not the investigation is being requested by an audit client. If it is, this poses extra ethical questions, as the investigating firm would be potentially exposed to self-review, advocacy and management threats to objectivity. Unless robust safeguards are put in place, the firm should not provide audit and forensic investigation services to the same client. Commercial considerations are also important, and a high fee level should be negotiated to compensate for the specialist nature of the work, and the likely involvement of senior and experienced members of the firm in the investigation.

Planning the investigation

The investigating team must carefully consider what they have been asked to achieve and plan their work accordingly. The objectives of the investigation will include:

- identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed
- identifying the fraudster(s) involved
- quantifying the financial loss suffered by the client
- gathering evidence to be used in court proceedings
- providing advice to prevent the reoccurrence of the fraud.
- The investigators should also consider the best way to gather evidence – the use of computer assisted audit techniques, for example, is very common in fraud investigations.

Gathering evidence

In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Evidence can be gathered using various techniques, such as:

—*testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated*

—using analytical procedures to compare trends over time or to provide comparatives between different segments of the business

—applying computer assisted audit techniques, for example to identify the timing and location of relevant details being altered in the computer system

—discussions and interviews with employees

- —substantive techniques such as reconciliations, cash counts and reviews of documentation.

The ultimate goal of the forensic investigation team is to obtain a confession by the fraudster, if a fraud did actually occur. For this reason, the investigators are likely to avoid deliberately confronting the alleged fraudster(s) until they have gathered sufficient evidence to extract a confession. The interview with the suspect is a crucial part of evidence gathered during the investigation.

Reporting

The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the entity to prevent any similar frauds occurring in the future.

Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified. It is imperative that the members of the investigative team called to court can present their evidence clearly and professionally, as they may have to simplify complex accounting issues so that non-accountants involved in the court case can understand the evidence and its implications.

Significant Differences between External Audit and Forensic

1. The main objective of an external audit is to design and perform audit procedures in such a way as to enable the auditor to express an opinion whether the client's financial statements

- Have been prepared, in all material respects, in accordance with an applicable financial reporting framework; or
- show a true and fair view or are free material misstatements due to fraud or error.

Auditors do not plan their audits for purposes of detecting fraudulent occurrences.

On the other hand forensic accounting aims in finding whether (i) fraud has been committed, (ii) how has it been committed, (iii) what is the extent of the damage or how much has been lost, (iv) who is (are) the fraudster(s), (iv) identify the fraud risk and advice ways of controlling frauds

2. Auditors are required to examine the financial statements to find out whether there are material misstatements due to fraud or error.

A forensic investigation is not interested in detecting errors. It is only interested in detecting the alleged or suspected fraud

3. An external audit report is prepared for the use of the owners of the client and other various groups persons such as, the potential investors, the managers, money lenders like banks, financial analysts, suppliers of goods or services, the client's customers the government etc.

But the forensic audit report is prepared for the use of a person who hired a forensic accountant and in most cases for the use of courts during litigation.

4. External auditors conduct their work on sampling basis because it is not practical for an auditor to test 100% of voluminous transactions. They collect samples of transactions and account balances to determine whether they show a true and fair view and the results of the transactions are generalized to the populations. An intrinsic limitation of sampling is that all transactions are not tested; therefore creating a high probability that a fraudulent transaction may not ***captured*** in the auditors' sample and, therefore, will go undetected.

In forensic accounting there is no sampling. All items under allegation are subject to examination

5. Usually, external audits examine the financial statements of an organization for a specific period; usually a 12 months period. The audits are being performed every financial year as far as the business is in operation and for public limited companies this is a statutory requirement though certain organizations may be exempted.

But for forensic accounting fraud examination is usually conducted whenever there is an allegation or a suspicion for fraud.

6. External auditing is required to comply with audit standards such as the International Standards on Auditing (ISAs). If an auditor decides not to comply with a certain standards then he or she should explain the reasons for non-compliance and the effects thereof.

On the other hand there are no standards for forensic investigation. However, a forensic auditor is required to observe and adhere to all ethical standards

7. Auditors are only interested in examining the quantitative and qualitative material items in the financial statements. They are not interested in quantitative misstatements.

. An audit aims at providing reasonable assurance that the financial statements are free from misstatements whether due to error or fraud. Reasonable assurance is a high level assurance but it is not an absolute assurance

A forensic accounting aims at providing a conclusive assurance whether the fraud has either occurred or has not occurred. A conclusive assurance is an absolute assurance

9. Audits require auditors to collect persuasive evidence and not conclusive evidence. This is due to several limitations of an audit.

A forensic investigation requires an engaged practitioner to collect total or conclusive evidence

10. At the conclusion of their work external auditors are required to express an opinion according to audit standard. There are four types of audit opinions: an unmodified, a qualified, an adverse and a disclaimer of opinion. The opinions are documented in audit reports.

11. In very few cases external audit results lead into litigation in the courts of law

Forensic audits usually lead to litigation. The aggrieved persons will sue the fraudster(s)

12. External audits do not aim at recovering the loss or damage caused by the fraudsters

Forensic audits helps to recover losses or damage caused by the fraudster(s)

13. Evidence collected in an external audit is usually not admissible during litigation for proving the occurrence of fraud

Evidence collected during forensic investigation is usually used during litigation.

14. External audit reports can be provided to the general public

Reports form forensic investigations cannot be provided to the general public. It is confidential , but can be used in courts

15. Generally, an external auditor cannot stand as a witness in a court of law

A forensic auditor can stand as a witness in the court of law

QUESTION

One of the earliest cases concerned with auditors' duties to detect fraud was Kingston Cotton Mill Co. (No. 2) (1896). This is a classic case which the auditing profession has relied on implicitly almost since the judgment was given by the learned Lord Justice Lopes in 1896.

Facts of the case:

For several years the manager of the Kingston Cotton Mill had been exaggerating the quantities and values of the company's inventory so as to fraudulently overstate the company's profits. This came to light when the company was unable to pay its debts and its true financial position was revealed. The auditor relied on a certificate signed by the manager and ensured that the amount appearing in the accounts was consistent with that certificate. The valuation of inventory was described in the accounts as being as 'per manager's certificate'.

In line with contemporary practice, the auditor did not physically observe inventory or attempt to verify the valuation of individual items. Neither did the auditor reconcile inventory with the opening balance and purchases and sales during the year, all of which would have put the auditor on notice that something was amiss. In this case it was held that it was not the duty of an auditor to take stock and that they were not negligent in accepting a certificate signed by company's officials as long as they had no suspicion of fraud. Lopes L.J gave his famous and much over-quoted dictum that that the role of the auditor is that of is "a watchdog, not a bloodhound."

Lopes went on to say

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors.

Required

Discuss whether the Kingston Cotton Mill Co. (1896) case is still valid in relation to the International Standard on Auditing (ISA) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*