

# Forensic Accounting And Auditing: Compared And Contrasted To Traditional Accounting And Auditing

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## ABSTRACT

*Forensic versus traditional accounting and auditing are compared and contrasted. Evidence gathering is detailed. Forensic science and fraud symptoms are explained. Criminalists, expert testimony and corporate governance are presented.*

**Keywords:** Accounting, Forensics, Auditing, Fraud symptoms, Interview techniques, Corporate governance, Sampling, Computers, Testimony, Criminalistics

## INTRODUCTION

This paper begins by defining *forensic accounting* and describing differences between it and traditional accounting and auditing. The paper then explains the role of forensic accountants. This includes identifying knowledge and skills forensic accountants are expected to possess. Forensic accountants' opportunities are described along with the organizations that support their work.

Forensic accountants are viewed as a combination of an auditor and private investigator. Knowledge and skills include the following: investigation skills, research, law, quantitative methods, finance, auditing, accounting and law enforcement officer insights. Investigation skills will be covered later in the paper. Organizational behavior and applied psychology knowledge and skills are essential.

Forensic accountants have been employed by the Federal Bureau of Investigation (FBI), Central Intelligence Agency (CIA), Internal Revenue Service (IRS), Federal Trade Commission (FTC), Homeland Security, Bureau of Alcohol, Tobacco and Firearms, Governmental Accountability Office (GAO) and other government agencies. The focus is on what is referred to as white collar crime. This is why financial and other skills are required.

Outside of government employment, big employers of forensic accountants include financial intermediaries such as banks and insurance organizations plus divorce attorneys. Forensic accountants often testify in civil and criminal court hearings. In this capacity, they are serving as expert witnesses. They do not testify as to whether fraud has occurred. This is the court's decision. The expert witness presents evidence. Forensic accountants have a number of organizations that support their work.

Here is the list of key organizations that support forensic accountants work along with the URL to access them: Association of Certified Fraud Examiners (<http://acfe.com>); American College of Forensic Examiners ([www.acfei.com](http://www.acfei.com)); Association of Certified Fraud Specialists ([www.acfsnet.org](http://www.acfsnet.org)); National Litigation Support Services Association ([www.nlssa.com](http://www.nlssa.com)); National Association of Certified Valuation Analysts ([www.nacva.com](http://www.nacva.com)); American Institute of Certified Public Accountants ([www.aicpa.org](http://www.aicpa.org)); and The Institute of Business Appraisers ([www.go-iba.org](http://www.go-iba.org)).

**Forensic accounting** standards evolve from courts of law. **Financial accounting** standards are set by the Securities and Exchange Commission (SEC) for corporations whose securities such as common stock are exchanged

on United States (US) stock exchanges, such as the New York Stock Exchange. The SEC delegates much of the financial accounting standard setting process to the Financial Accounting Standards Board (FASB). Financial accounting standards are not laws.

Forensic accountants and auditors share some goals similar to traditional accountants and auditors. They have different roles, knowledge and skills. Forensic accountant investigations include identification of fraud. This is different from Certified Public Accountant (CPA) investigations that are not responsible for identifying fraud. Forensic accounting investigations include litigation services related to a variety of situations including the following: business purchases, valuation of divorce assets, property damage, lost profits due to embezzlement and other illegal acts, tax evasion, and money laundering schemes.

**Table I**  
**Differences Between Auditors and Forensic Accountants**  
**Regarding Error Identification, Error Prevention and Fraud Identification**

	<b>Error Identification</b>	<b>Error Prevention</b>	<b>Fraud Identification</b>
<b>Auditor</b>	X	X	
<b>Forensic Accountants</b>			X

Traditional auditing is a process of reviewing others work to determine if they have followed the prescribed policies, procedures and practices. The determination is based on evidence. It is a matter of fact and not merely a matter of opinion. There are basically two types of auditors. There are internal auditors and external auditors. Internal auditors are employees of the organization being audited. External auditors are employees of an auditing organization that is contracted to come in and audit for a specified time period and purpose. The Institute of Internal Auditors (IIA) awards the Certificate of Internal Auditor (CIA) once an individual has passed an exam and meets specified work experience requirements. External auditors are typically CPAs who passed an exam and met work experience requirements as specified by state associations of CPAs. Audits are required by financial intermediaries and the government depending on circumstances.

Traditional auditing has a focus on error identification and prevention. Prevention is the result of an effective internal control system. The auditor reviews the effectiveness of the internal control system by sampling transactions and not by a complete review of all transactions. The process can reveal errors. All errors are not considered equal. Some are important and are referred to as material. For example, omission of a million dollar loan that is not recorded in the accounting records might be a material error. Other errors are not material. An example of an error that might not be material would be a math error due to rounding that causes the reported amount to be ten dollars more or less than the actual amount. These examples are not meant to imply that there are absolute dollar amounts that denote the difference between material and not material (e.g., immaterial).

Materiality is the accounting way of designating the importance of a transaction or an event. If it is material, then it is important. Audit risk is defined relative to whether material errors will be found. This requires judgment. Auditors use statistics to determine the probability that material errors will or will not be identified. This is a concern since only a sample of transactions and events will be reviewed. The system of internal control is evaluated. If the internal control system is deemed to be highly effective, then material errors are not probable. Smaller sample sizes are used in doing the audit. If the internal control system is deemed to be less than highly effective, then material errors are probable. The degree of probability is a function of the reliability of the internal control system.

Banks and other financial intermediaries often required financial statements to be audited before they will loan money to an organization. The SEC requires publicly traded corporations to have their financial statements audited.

## **REGULATION**

External auditors who are CPAs are regulated by the state association of CPAs that issued their license. All state associations belong to the National Association of State Boards of Accountancy (NASBA) ([www.nasba.org](http://www.nasba.org)). CPAs and CIAs must complete a number of continuing professional education (CPE) hours each year or the license will be taken away. The requirements to become and continue being a CIA are detailed at the web page for the IIA ([www.theiaa.org](http://www.theiaa.org)). Certified fraud examiners also must complete CPE each year. ([www.acfe.com](http://www.acfe.com)).

## **RULE-MAKING BODIES**

Traditional auditors typically adhere to the generally accepted auditing standards (GAAS) as promulgated by the Public Company Accounting Oversight Board (PCAOB). This organization's web page is at [www.pcaob.com](http://www.pcaob.com). External auditors are typically reviewing whether an organization is following GAAP. GAAP are promulgated by the Financial Accounting Standards Board (FASB) ([www.fasb.org](http://www.fasb.org)). The SEC supervises both of these organizations. This means that auditors are affected by all three of these organizations and must stay current with old, new and changing standards and principles issued by all three of these organizations. Internal auditors are employees of an organization and address the responsibilities assigned by the employer.

## **TRADITIONAL AUDIT REPORTS**

Audit reports provide a degree of assurance to those who used audited financial statements. The language of the audit report is very specific. It can be confusing to individuals who are not knowledgeable of the language of business, which is accounting. For example, an unqualified audit report is desirable. Unqualified sounds like a bad evaluation. A person who is unqualified is thought of as not having the required qualifications for something. An audit report that is unqualified is perfect. It means that there are no qualifications that were not met. Sounds like an attorney talking in double negatives. Attorneys played a role in the development of the audit report language. It is too strong of a statement to say that all of the qualifications were met. It might sound like the same to most people, but it is a legal issue. The audit report does not promise that everything is perfect when an unqualified report is issued. It merely states that no material imperfection was found. When an audit report is qualified it is typically due to the organization using accounting principles other than the GAAP or the scope of the audit was limited. Scope refers to whether the auditor was allowed to gather the needed evidence. Worse than a qualified report is an adverse report where there are material problems with the financial statements. The third type of report is the disclaimer report where the auditor does not express an opinion on the financial statements.

## **AUDIT ASSERTIONS**

An assertion is a statement. Audit assertion refers to the organization's management's statements. The key qualities of how the statements are presented and disclosed are the following: occurrence and rights and obligations; completeness; classification and understandability; and accuracy and valuation. Traditional and forensic accountants and auditors gather evidence regarding the organization's assertions.

Rights and obligations are where the organization holds or controls the title to assets and liabilities. Existence or occurrence of the assets, liabilities, events and transactions must be documented with evidence. The evidence must be complete. It must provide support for valuation and allocation methods. Third standard about audit documentation is at the following URL: [http://www.pcaob.org/Standards/Standards\\_and\\_Related\\_Rules/index.aspx](http://www.pcaob.org/Standards/Standards_and_Related_Rules/index.aspx).

## **EVIDENCE-GATHERING PROCEDURES**

Confirmation is where the auditor checks with third parties regarding the aspects of the audited organization's management assertions. Auditors can also observe using the senses such as sight and touch to gather evidence that confirms or refutes management's assertions. One form of observation is to do a physical examination of tangible items and processes that can be seen.

Re-performance is where the auditor duplicates processes management asserts were completed to see if the results of the process are identical to those asserted by management. Another approach to gather evidence is to compare asserted and expected results using analytical procedures. This is where the concept of reasonableness emerges. Identifying reasonableness is a skill that evolves through education experiences.

Where there is inconsistency or missing evidence or a lack of reasonableness, auditors ask the organization management. This is called inquiry of client and it with all of the methods just mentioned is part of the documentation process.

## **AUDIT TESTS**

Tests of controls are used to determine the required sample size. This is where information systems expertise is vital. If the information system is secure, then the internal control is deemed to be strong. If the internal control strength is good, then a smaller sample size is used. Whatever the sample size, auditors do substantive tests of transactions. This is checking to see if the transactions and events were correctly measured and recorded in the financial statements.

Analytical procedures are another form of looking for reasonableness. It takes a level of expertise based on education and experience to be able to interpret the results of efforts to check for anything that might be unusual. Auditors look for evidence that corroborates and supports management assertions.

## **SAMPLING**

Sampling is the examination of less than the total population. Determining how much less than the population is a function of sampling risk. Sampling risk is the possibility that the sample does or does not represent the total population. Two sampling methods regularly used are statistical and judgmental. Statistical sampling uses math probabilities. Judgmental sampling uses auditor opinion based on experience and expertise. Statistical sampling is easier to replicate and harder to debate.

Sampling for attributes has three steps that are planning, performance and evaluation. The goal is to estimate the proportion of particular characteristics existing in the total population. This helps the auditors determine the size and selection of items that make up the sample.

Sampling for substantive tests of balances is checking the account totals as to reasonableness. Acceptable risk of incorrect acceptance refers to where account balances are deemed to be not materially incorrect when they are incorrect.

Non-statistical sampling for tests of balances is where auditor judgment again is used. While judgment is used regularly it is for the experienced. The audit process is described on web pages for audit organizations such as Ernst and Young. ([http://www.ey.com/global/content.nsf/International/Services\\_-\\_Assurance\\_&\\_Advisory\\_Business\\_Services](http://www.ey.com/global/content.nsf/International/Services_-_Assurance_&_Advisory_Business_Services)).

The first step is to properly plan and design the audit to assure efficiency and effectiveness. Understanding the organization within the industry and economy along with the internal control comprise part of the planning. Once the plan and design are established, then the auditor performs tests of controls and substantive tests of transactions as discussed earlier. The auditor then performs analytical procedures and substantive tests of balance. This results in the completion of the audit and issuance of the audit report.

The responsibilities of auditors and management with respect to the assessment of controls over financial reporting are presented in Auditing Standard number two that you can find at the PCAOB. ([http://www.pcaob.org/Standards/Standards\\_and\\_Related\\_Rules/Auditing\\_Standard\\_No.2.aspx](http://www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx))

The auditor seeks to identify any internal control design deficiencies. The auditor's evaluation process focuses on determining if there are any material deficiencies in the internal control system. The process results in a report on internal control quality over financial reporting

The auditor's responsibility to detect fraud is detailed in Statement on Auditing Standards (SAS) number 99, which is entitled consideration of fraud in an financial statement audited. (<http://www.aicpa.org/pubs/cpaltr/nov2002/supps/busind1.htm>) It will take you to guidance provided by the American Institute of Certified Public Accountants (AICPA). While the organization's management is responsible for preventing and identifying financial fraud, auditors are supposed to consider the possibility of fraud.

Other services provided by accountants and auditors include reports on specified elements, accounts, or items on financial statements. The auditor and organization can agree upon a procedures engagement that is a small part of an audit. Often auditors complete compliance reports measuring whether the organization has complied with legal or other specifications. This is a partial audit. Auditors can do a review that is like a mini-audit. It results in a statement such as that no material modifications to the financial statements are required. Auditors should never assure an organization's prospective financial statements. Specialty assurance services include reviews of Internet web sites. Auditors can complete a compilation that results in the financial statements being put together.

Internal auditing is typically completed by an auditor who is an employee of the organization. Internal auditor educational and experience requirements are detailed at use the Internet web address for the IIA (<http://www.theiia.org/>).

Operational auditing is reviewing whether the organization's processes are working consistently with the way that management says they are working or operating. Governmental auditing is guided by the GAO (<http://www.gao.gov/>). In 1984, the single-audit act was issued and then amended with the issuance of the Office of Management and Budget (OMB) Circular A 133. This publication is available at the Internet web address (<http://www.whitehouse.gov/omb/circulars/a133/a133.html>).

## **Forensic Science**

Forensic comes from the Latin word for public and specifically to forum. The forum was where the ancient Romans were thought to gather to do business and settle disputes among other things. Forensic now relates to courts of law. It refers to legal concerns. Crime solving is the focus. Forensic relates to the application of knowledge to legal problems such as crimes. It is science based. To say forensic science is to almost be redundant.

Forensic is the application of science to crime concerns. However, science does is not related exclusively to crime. So the two words are not interchangeable. Forensic science is science applied to legal matters especially criminal matters.

## **CRIMINALISTICS**

Criminalistics is forensic science applied solving crimes. It focuses on the proper collection, preservations and analysis of evidence. This includes the study of fingerprints along with other body-related evidence such as blood and hair and DNA. Forensic accountants practice criminalistics, but with the focus on computer and document-related evidence. This includes studying old handwritings. To learn more about this go to <http://www.aicpa.org/pubs/cpaltr/nov2002/supps/busind1.htm>. While the web site provides information about studying very old handwriting, forensic accountants study not so old handwriting and documents in general. The Greeks referred a very old document as a diploma.

The documents can be handwritten or generated using technology including a typewriter or computer. Forensic accountants seek to use documents to gather evidence relative to crime solving. Forensic accountants must work with people to gain access to documents. For this and other reasons addressed later in this lesson and future lessons, forensic accountants must develop communications skills similar to a psychologist or psychiatrist.

## **CRIMINALISTS**

The major players in forensic investigations include criminalists sometimes referred as forensic science technicians. There are associations of criminalists. The web page of an example association of criminalists is at [www.cacnews.org](http://www.cacnews.org).

Forensic Scientists usually work in a laboratory rather than at a crime scene. There is an American Academy of Forensic Sciences ([www.aafs.org](http://www.aafs.org)). This organization is devoted to the improvement, the administration and the achievement of justice through the application of science to the processes of law.

Crime labs typically examine the following types of evidence: fluids, such as blood; unknown substances, such as drugs and poisons; trace evidence, such as hair or fibers to be studied under a microscope; ballistics as related to projectiles such as bullets and bombs and rockets; and fingerprints.

Forensic accountants focus on documents. The documents are most often created and maintained within an information system on a computer. Understanding information technology is essential for success in the process of forensic accounting.

## **FORENSIC EVIDENCE**

To assist in the process of identifying suspects and criminals, forensic accountants use physical evidence, testimonial evidence, documentary evidence and demonstrative evidence. Testimonial evidence can be explored in some detail at the web site [www.crimesandclues.com/testimony.htm](http://www.crimesandclues.com/testimony.htm). Regarding testimonial evidence, the web site includes the following quote:

“Because they rarely come upon a crime in progress, police depend on members of the public for knowledge that a crime has been committed. They are equally dependent on victims, witnesses and other informants for knowledge of who the offender is and where he might be found. To exaggerate just a bit, the police can solve a crime if someone tells them who committed it.”

Documentary evidence used to be defined as paper, but it now is defined as any type of recorded information. It could be in a computer or video or audio. It does not typically stand alone. It requires an expert to interpret and present it. Demonstrative evidence is not actual evidence. It is an aid to understanding. A model of a body part or pictures or other devices are used to help clarify the facts. Typically an expert witness is needed to interpret the demonstrative evidence. Profiling is used in the process of identifying suspects and criminals. There is an Academy of Behavior Profiling ([www.profiling.org](http://www.profiling.org)). The home page states that the Academy of Behavior Profiling is a professional association dedicated to the application of evidence based criminal profiling techniques within investigative and legal venues. The mission statement includes the promotion of public awareness of evidence based crime analysis and behavior profiling.

## **EXPERT TESTIMONY**

To serve as an expert witness for a lawsuit or criminal case in a court, the forensic accountant needs to have applied reliable principles and methods to sufficient facts or data. The expert witness is a recognized specialist relative to the principles and methods applied to the sufficient facts or data.

Specialization is documented training and knowledge such as that described in the web site ([www.profiling.org](http://www.profiling.org)). When investigating computer-related evidence, the forensic accountant should assure that the evidence not altered, damaged, contaminated, or destroyed by investigative process. The forensic accountant must try to assure that malicious software is not permitted to infect or corrupt. Relevant evidence should be extracted and fully preserved.

## **CHAIN OF CUSTODY**

This is similar to the audit trail that accountants learn about when studying auditing standards and processes. It focuses on control in the transfer and analysis and disposition of physical and electronic evidence. The process should cause minimal interruptions to business and overall organization operations during investigation. The process should maintain privacy and confidentiality.

## **FORENSIC COMPUTER INVESTIGATION**

To conduct a forensic computer investigation, the forensic accountant should size up situation, log every detail, conduct an initial survey and assess the possibility of ongoing undesirable activity. Regarding the information technology and systems, the computers should be powered down and checked for booby traps. The forensic accountant should duplicate the computer hard drive or other permanent storage unit first and then analyze the hard drive.

When financial statement fraud is not suspected, it is important to remember that **Generally Accepted Accounting Principles** (GAAP) are only *generally accepted*. If an organization fully discloses the alternate accounting principles being used and uses them consistently, then it is not fraud.

The primary objective of a financial statement is to provide information that is useful to decision makers. Even the GAAP can be interpreted more than one way. Different interpretations do not constitute fraud because fraud exists only when there is intentional misstatement. It is often difficult to clarify a person's intent. The following procedures have been developed to audit when fraud is not suspected: confirmation, observation, physical examination, re-performance, performance of analytical procedures, inquiry of client, and documentation.

## **FRAUD SYMPTOMS**

Fraud symptoms are unusual and unexpected changes. An inexperienced person might not have knowledge or awareness of what is usual or expected or what constitutes change. The fraud symptoms are usually financial-record or person-related. Fraud symptoms are investigated by analyzing documents and document-related items for financial record symptoms. Person-related symptoms include personality and life-style changes. If people are living beyond their earned income level, then there may be reasons for their behavior unrelated to fraud. Such reasons may include receiving an inheritance or being deep in debt.

Behavior changes such as being more or less argumentative may have nothing to do with committing fraud, but these changes have been correlated to fraud activity in past cases. Document analysis has evolved into a science for paper documents. Handwriting and ink analysis are two examples. Computer-generated documents that do not get printed out provide an opportunity for developing different analytic techniques.

Evidence sources that are helpful to the forensic accountant include real estate records, court records, assumed name indexes, Uniform Commercial Code filings and other public records as maintained by a county clerk. Restricted sources can be accessed by certain people. A forensic auditor might need to get help from people such as law enforcement or government personnel. These individuals can access federally restricted databases

Specialized audit techniques that can be applied in cases of suspected or actual fraud include supervising, search warrants, surveillance, source and application of funds, and tips similar to anonymous complaints. Supervising includes observing, physically examining and documenting evidence. As noted earlier in this lesson, comparing *expected* to *actual* is key to this process. Search warrants are issued by judges upon review of the appropriate application. The judge decides if probable cause exists so that a search is warranted. Surveillance includes watching and sometimes going through the suspect's trash.

The most successful technique is from anonymous complaints or tips. Organizations benefit from having a process where customers and employees can provide information without revealing their identity.

Many organizations encourage customers to complain by stating that their purchase will be free if the receipt from the cashier is inaccurate.

## **INTERVIEW AND INTERROGATION**

Interview and interrogation as evidence-gathering techniques involve asking people questions. The basic difference is that interrogation is confrontational while interviewing is not. In either case, the interviewer records both the answers to the questions and physical behaviors; these may include the interviewed person looking at the floor rather than making eye contact.

Key information to gather centers on the suspect's pressures: Being deep in debt; Perceived opportunities such as having access to the organization's assets; and Rationalization due to being passed over for a promotion. Effective interviewing is a skill that can be enhanced with continuous education and practice.

## **VERBAL AND NONVERBAL CUES**

Verbal cues can be written or spoken. Nonverbal cues given by interviewed subjects include crossing the arms over the chest and also crossing legs. These clues often convey hidden meanings such as being closed and possibly hiding something.

To comfort the person being interviewed, it can be helpful for the interviewer to mirror the physical behaviors of the person being interviewed. Research indicates that this makes the interviewed person feel that the interviewer is on his or her side. Physical behaviors are called nonverbal cues.

Eye movements are in this category as well. The interviewer needs to watch for patterns and ask test question to confirm the patterns. This is needed for verbal cues given while talking. For example, answering a question by asking another question is typically an attempt to deceive. Also saying, "To the best of my knowledge," often indicates such an attempt.

## **QUESTION TYPES**

Question types that interviewers can use to obtain relevant and useful information include closed ended, forced choice, open ended, connecting, positive reaction, clarifying, compound, confrontational, and secondary. Closed ended questions are like multiple choice test questions. It can be as simple as a yes or no question or it can have a limited number of choices. This is called a **forced choice**. The downside of this format is that the correct choice might be missing and evidence might not be uncovered.

Open ended questions provide very little guidance from the interviewer. The interviewed person is also allowed to give details on feelings. Connecting questions try to connect or tie details together to determine where the fraud took place.

Positive-reaction questions are like closed ended questions but the question is set up to get the person being interviewed to say "yes." Saying yes is believed to put the person being interviewed into a cooperative mood. Clarifying question build on responses to other questions. Compound questions can be confusing and should be avoided.

Confrontational questions are like a little speech pointing out evidence that is not consistent or that contradicts other evidence. Secondary questions are usually just repeating back the interviewed person's response in hopes of getting further clarification. No matter what types of questions are used, they should be used subject to a plan.

## **TECHNIQUES TO PERSUADE**

Different approaches that interviewers can use to persuade subjects to cooperate include the direct approach, non-direct approach and a combination of these two approaches. The goal is to gather and document relevant and reliable evidence that leads to a conviction where fraud has occurred.

The direct approach reveals selected existing evidence and does not deceive the person being interviewed. The non-direct approach allows the person being interviewed to ramble. It is similar to the idea that if you give a person being interviewed enough rope, he might hang himself. A variation on these two basic approaches includes just being silent to see what the interviewed person might say. On the other hand, many questions can be asked rapidly. Appealing to emotions including changing to a different location can be used to make the interviewed person feel more comfortable and willing to reveal information.

Admission-seeking interviews use the ideas and techniques introduced earlier in this lesson to get the suspect to admit guilt. Guilty people are often silent. The suspect could also offer a special type of explanation, the **alibi**, to convince the interviewer of innocence.

## **SIGNED CONFESSION**

The content of the signed confession includes a concise statement of guilt and that the statement was made voluntarily. It should include a statement that the person signing the confession knew fraud was being committed and when it was being committed. It should also include an estimation of the monetary value of the loss or crime.

The interviewer should bring a hard copy of the confession to the interview for the suspect to sign. If time goes by between the agreement to sign the confession and the actual signing, the confessing person might decide not to sign. The interviewer needs to be prepared to “strike when the iron is hot,” as they say. This includes having a hard-copy permission statement ready for signing regarding voluntarily turning over assets such as checking and saving accounts.

## **FINANCIAL STATEMENT FRAUD**

*Financial statement fraud* is intentionally violating the Financial Accounting Standards Board’s Concept Statement number one that states that financial statements are to provide information that is useful to decision makers. Misrepresentations are not useful. Intentional misrepresentation constitutes fraud.

Legal recourse is available when the decision maker relies on the misrepresented information and injury results. The injury is typically financial. Without intentional misrepresentation it is not fraud. For example, someone could make decisions using financial statements that do not contain intentional misrepresentations and the decision results in loss when profit was the goal. This is poor decision making and not fraud.

## **FRAUD SCHEMES**

Financial statement fraud schemes typically include overstatement of revenues and assets, understatement of expenses and liabilities, asset misappropriation and inappropriate disclosure. Inventory manipulation has been very popular and has been somewhat curbed by income tax law requiring that the inventory method used for tax be the same as that used for financial statements. For example when prices were rising, corporations would use the first in first out inventory method for financial statements and the last in first out inventory method for the tax reports. This resulted in a much higher reported profit for financial statements than for tax reports.

Corporations would purchase extra inventory near the year end to increase the reported cost of goods sold for tax reports and thereby decrease the actual tax due. Shortly after the beginning of a new reporting period, the corporation would return the excess inventory to the suppliers.

This is just one of many examples where laws were passed requiring that financial and tax accounting methods to be identical. These requirements were legislated due to extensive manipulations that borders on or crosses the border into fraudulent financial statement reporting. This inventory illustration is an example of overstating assets for financial reports and overstating expenses for tax reports. While financial examples focus on overstating revenues and understating expenses, there are other variations on the theme of fraud. These will be presented later in this lesson.

## **FRAUD CHARACTERISTICS**

Typical characteristics of financial statement fraud include misstatement or misappropriation of assets. To keep the balance sheet *balanced*, the liabilities and owners' equity usually are misstated or impacted when assets are misstated or misappropriated.

For example, when asset book values are overstated, the owners' equity is usually overstated. This increases the book value of owners' equity and thereby protects the debt to equity ratio. If the debt to equity ratio is not maintained at a certain level as prescribed by creditors, then the creditors can step in and increase the interest rate or speed up the repayment schedule. Both of these actions have the potential of pushing an organization into bankruptcy and thereby jeopardizing the organization's status as a going concern.

Protecting the organization's image as a going concern is one motivation for managers to commit fraud. More motivations will be briefly presented shortly.

Most organizations that have fraudulent financial statements did not have an audit committee. Having an audit committee is one of the requirements of the Sarbanes Oxley Act of 2002. The Sarbanes Oxley Act also explicitly puts the responsibility for preventing and detecting and correcting fraud on the organization's management and not on the auditors.

Management's motives to commit fraud are thought to focus on protecting a job or a potential bonus when performance is evaluated relative to financial statement results. Managers have said that a motivation to commit fraud was to make the organization appear to be a going concern so that the organization could acquire and keep excellent employees, suppliers, customers, creditors and investors. The motivation *almost* sounds good enough to justify the fraud. Another motivation to commit fraud what is called insider trading, which is discussed next.

## **FINANCIAL STATEMENT FRAUD HARM**

Financial statement fraud that harms individual investors, financial markets, and society includes the loss of retirement funds, employment, community economics and economies. Fraudulent practice of insider trading is an example. Insiders are corporate managers. Trading refers to buying or selling of the corporation's common and preferred stock. Usually the stock that is purchased is authorized, but not yet issued stock.

When the manager buys the stock, it is purchased directly from the corporation and not from current stock holders. The new stock dilutes the value of the existing outstanding stock. Before the existing stockholders learn of the new issuance of stock, the managers have sold the new stock at the existing market value that does not reflect the actual decline due to dilution caused by the increase in the number of shares representing an unchanged corporate total value.

Insiders or managers know about both good and bad news for the corporation before the impact of the news is reflected in the financial statements. Managers use this news to buy or sell stock for their personal economic advantage. In the year 2006, the Securities and Exchange Commission addressed the reporting of stock option exercising. The time frame has been shortened.

Stock options are given as both an incentive and a reward to managers. The option is an opportunity to purchase common or preferred stock at a certain price. The option is an opportunity to purchase common or preferred stock at a certain price. Managers would wait for the stock price to rise and then pretend to purchase the stock days or even weeks earlier when the stock price was lower. Since the stock was purchased directly from the corporation and was

part of the authorized but unissued stock, it was relatively easy for the corporation to record an earlier date than the actual transaction occurred.

Recording an earlier date than the actual transaction occurred is called back dating. The purchase would be back dated and the managers would immediately sell the stock for personal profit. Existing stockholders experienced personal loss. Sometimes this was a dramatic loss for the existing stockholders and thereby the organization.

## **CORPORATE GOVERNANCE**

Corporate governance can mitigate financial statement fraud through the process of greater supervision of the organization. This process is also called *oversight*. Oversight is so important that it is included in the title of the organization that replaced the American Institute of Certified Public Accountants regarding the development of auditing standards. This organization is the **Public Company Accounting Oversight Board (PCAOB)**.

The Sarbanes Oxley Act was the legislation that mandated the establishment of the Public Company Accounting Oversight Board. Some of the standards promulgated by the Public Company Accounting Oversight Board include the following: Every five years, the primary or reviewing audit partner must be changed for each client. Working papers must be maintained for a minimum of seven years. This is partially due to documents being shredded relative to a number of famous fraud cases. A few of these famous fraud cases will be briefly presented later in this lesson.

The internal control system of an audited organization must be evaluated and any material weaknesses disclosed.

Formal and official ethics standards must be adopted by each auditing organization. Major components of these ethics standards must include clarity about the organization's independence from the audited organization along with how the audit process is accepted and planned and supervised.

Other oversight groups that do not actively operate the organization include the organization's Board of Directors, Audit Committee and external auditors. Increased oversight is expected by the organization's internal auditors as supervised by top managers such as the Chief Executive Officer and the Chief Financial Officer. It is hoped and believed that if an organization has a strong audit committee and excellent external audit process that fraud will be deterred. However the responsibility and blame for fraud rests exclusively at the feet of management and not at the feet of the audit committee or the external auditors.

## **FRAUD INDICATORS**

After many dramatic fraud cases were identified, a list of red flags associated with these examples of fraud were developed. Had these red flags been noticed, then the organization's management or employees might not have committed fraud or it might have been caught sooner. The red flags include the following: Lack of independence between the organization's management, external auditors, audit committees and internal auditors; Lack of competence, oversight or diligence in or by the organization's audit committee and internal auditors; Weak internal control processes; Management style that pressured employees to take actions beyond financial statement management to manipulation to outright misrepresentation which is fraud.

Personnel-related practices allowing financial statement misrepresentation include low employee morale that is possibly due to inadequate compensation, high turnover and inexperienced managers. This tends to result when there is inadequate screening of potential employees and managers. Accounting practices indicating that someone has committed fraud include frequent external auditor firm changes, restatements of prior year reports due in part to large and frequent accounting errors.

An organization that loses financial records may have lost their financial records on purpose to hide fraud. Fraud is easier to commit when there is no strong accounting information system. Company's financial conditions that can indicate possible fraud include insider trading and inventory manipulation as has already been presented.

## **EARNINGS MANIPULATIONS AND MANAGEMENT**

Earnings manipulations and earnings management can be somewhat difficult to identify. The lack of clarity is part of the focus in the debate between whether accounting standards should be principles or rules. Management discretion is allowed with accounting principles, but would not be allowed with rules. The rules would be like laws.

Major financial frauds were committed as follows: McKesson and Robbins created fictitious sales and inventories. Great Salad Oil Swindle used the fact that oil and water do not mix to fraudulently over-state the quantity of oil in inventory tanks. The bottom part of the inventory tank was water and the top was salad oil. The auditors did not test all the way to the bottom of the tanks. Equity Funding was about fake insurance policies. Cedant Corporation was about fake revenues. Zzzz Best was a pyramid scheme. Sunbeam Corporation used what is called channel stuffing where revenue recognition is accelerated inappropriately. Nortel used what is called a big bath. Nortel had deferred recognition of expenses by recording as assets. This inflated total assets and total owners' equity. After several years, they wrote off the assets and recognized a huge loss that drove the owners' equity down. It washed away the profits.

Worldcom also recorded assets when they should have recognized expenses. Enron is well known for using Special Purpose Entities to hide huge losses. Enron creatively and fraudulently recorded non-existent revenues. Qwest and Global Crossing used what are called swap sales to inflate reported income.

## **SUMMARY**

This paper presented differences between traditional and forensic accounting and auditing. Both were defined and explained.

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