THE PURPOSE OF FORENSIC ACCOUNTING IN DETECTING OCCUPATIONAL FRAUD IN CONTEMPORARY CORPORATE GOVERNANCE

Maja Gligorić, Luna Đurić, Nada Arežina
Singidunum University, Belgrade, Serbia

Abstract:
Countries around the world, especially developed economies, are faced with a number of financial irregularities, as well as non-compliance with accounting standards and legal regulations in the form of criminal and fraudulent actions. Based on previous corporate and accounting scandals, the need for new skills in accounting practice has arisen. The main purpose of those skills is detection of different types of occupational fraud. Forensic accounting represents the application of accounting skills in litigation and criminal proceedings. This area mainly applies standards in the field of accounting and auditing, as well as evaluation of internal controls, fraud risk and any other matter involving accounting expertise in the legal system. The aim of this paper is to analyze development of forensic accounting and the need for its implementation, in order to detect and prevent fraud activities.

Keywords:
forensic accounting, occupational fraud, accounting standards, forensic accountant.

INTRODUCTION

Nowadays, business forensics represents one of the fastest growing sciences, and includes different fields, amongst which the most eminent ones are forensic accounting and forensic auditing. Overall, efficient implementation of business forensics and forensic accounting means preventing fraud activities in a timely manner, which affects the stability of industries and creates favorable conditions for business practices. The fact that criminal activities rates have significantly increased in recent years is indisputable, especially when it comes to fraud and manipulation activities. This situation affects countries around the globe, both developed and developing ones. Due to the aforementioned points, forensic accounting becomes a key factor in overcoming and preventing fraud activities, as well as financial statement fraud. Being the part of forensic science, forensic accounting is focused on the investigation of business and financial data, in order to determine whether a fraud activity has been committed. Previously mentioned activities include the following: money laundering, bribery, embezzlement, tax fraud, asset misappropriation along with others. Thus, forensic accounting represents a powerful tool for detecting all types of business fraud activities and will be defined more precisely later in this paper.

Although many companies run their businesses in accordance with accounting and legal regulations, plenty of accounting scandals unfolded in the last decade and, therefore, urged the development of forensic accounting. With the implementation of forensic accounting, it is possible to detect noncompliance with accounting standards and legislation, as well as other areas in which the most common fraud activities seem to appear. Depending on the literature being used, forensic accounting can also be referred

to as investigative accounting, but it is important to distinguish one from another. Investigative accounting is a component of forensic accounting and is usually applied in situations when fraud activities have already been committed. Among others, one of the most accurate definition of forensic accounting was given by the Association of Certified Fraud Examiners (hereinafter ACFE). It states that forensic accounting is the use of professional accounting skills in matters involving potential or actual civil or criminal litigation, including, but not limited to, generally acceptable accounting and audit principles; the determination of lost profits, income, assets, or damages; evaluation of internal controls; fraud; and any other matter involving accounting expertise in the legal system. Moreover, its expertise is based on legal and professional assistance, administrative and expert witnessing support.

The development of this specific area of accounting is directly affected by changes and developments in technology, society and economy. Moreover, continuing education is one of the ways that accountants, dealing with forensic accounting, adapt to the new challenges of the modern world. Although from the historical perspective, the field of forensic accounting has not always had a clear distinction from audit, it began to offer different types of services regarding fraud detection, and litigation services. Connections between these two areas represent dynamic relationship in which continuous harmonization is also required. Moreover, it is tremendously important to emphasize differences between these two professions. The auditor is an independent person with adequate knowledge and skills to form an opinion on whether financial statements, taken as a whole, are free from material misstatement, whether caused by a fraud or error. Although, the external auditor has some responsibility in considering the risk of material misstatement due to fraud, investigation of fraud is not auditor’s primary responsibility. On the other hand, forensic accountants are experts dealing with more detailed disclosure of all incidents of fraud and embezzlement, who in spite of knowledge of accounting and auditing standards, have expertise in various fields including mathematics, statistics, psychology, criminology, law, etc. Moreover, their expertise could include investigation of the assets misappropriation, financial statement fraud, corruption, money laundering and cybercrime. Therefore, forensic accountants usually use aggressive investigating approaches and expect their evidences in a way to be admissible in court. During the forensic process, an investigation is conducted and evidences are collected, in order to refute or prove the fraudulent actions. It is important to emphasize that forensic accounting cannot always completely prevent fraud activities from appearing, but it can significantly diminish effects of material losses. Despite the fact that forensic accounting was used to assist in legal proceedings, nowadays it is also being used in everyday business decision making processes. It is important to note that detecting fraud activities in a timely manner is of the significant importance for the further business development.

Based on the aforementioned points, it can be said that the main goal of forensic accounting is to protect organizations from potential financial statement fraud, asset embezzlements and any kind of occupational fraud within organization. Taking into account the vast number of accounting scandals, it is obvious that auditing does not foster adequate climate against frauds. Furthermore, financial statements auditing is not legally required for all organizations, which is a good reason for forensic accounting services to be used.

ANALYSIS OF THE ACFE AND AICPA STUDIES

This paper is based on the analysis of significance and need for forensic accounting in modern corporate culture. The research method is based on comparison and descriptive analysis, based on the data sources provided by the Association of Certified Fraud Examiners (hereinafter ACFE) and the American Institute of Certified Public Accountants (hereinafter AICPA), from 2011 to 2016. The 2016 ACFE Report to the Nations on Occupational Fraud and Abuse provides analysis of 2,410 cases of occupational fraud that occurred in 114 countries throughout the world. The research represents data regarding losses that have occurred and major occupational fraud categories. The 2014 AICPA Survey on International Trends, in Forensic and Valuation Services (FVS), includes 443 professionals participating, out of which 182 of them were FVS practitioners and 261 were business and industry professionals. The research is based on major issues facing FVS, which provides members of AICPA with advocacy, information and skills to perform forensic services on a high level of professionalism.

The ACFE has conducted the research in the year of 2016, aiming to show how great median losses caused by occupational fraud are, varied by region around globe. The following graph represents data concerning median loss by region:

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Due to the lack of established standards and regulations in the area of economy, the results of the research show that the greatest median loss occurred in the Middle East and North Africa ($275,000). On the other hand, the smallest median loss occurred in Southern Asia ($100,000).

According to the ACFE, participants in their survey pointed out that the typical organization loses 5% of revenues in a given year as a result of fraud, while the total loss caused by the cases in their study exceeded $6.3 billion, with an average loss of $2.7 million per case. The same research shows that the financial statement fraud has caused the biggest median loss, compared to asset misappropriation and corruption. The results of the research show that although this type of fraud occurred in less than 10% of cases, the median loss of financial statement fraud was $975,000, which is almost eight times greater than the loss caused by asset misappropriation and almost five times greater than the loss caused by corruption. Given that financial statement fraud in organizations is quite difficult to detect on time, including highly sophisticated methods used for manipulation of financial data, it comes as no surprise that occupational fraud of that kind causes the greatest losses.

The AICPA survey on International Trends in the year of 2014, in Forensic and Valuation Services focused on major issues forensic accounting faced for the year 2011 in comparison to the year 2014. The major issue of year 2011 was obtaining qualified staff, but in the year of 2014, this issue was significantly reduced (Table 2 and Table 3). The technology did not seem as a major issue in 2011, but in 2014, there seemed to be an issue with electronic data analysis i.e. accessing and analyzing voluminous amounts of information. This is not surprising, since International Data Corporation forecast that the big data technology and services market would grow at a 27% compound annual growth rate to $32.4 billion through 2017, which would be roughly six times the growth rate of the overall information and communication technology market. The aforementioned results demonstrate that this growth would have an impact on FVS professionals, even if they did not work directly in this practice field. The second major issue in 2011 was regulatory changes, while in 2014, this situation has improved and the rates dropped from 14% to 11%. Moreover, it is important to emphasize that forensic accounting today still does not provide their services based on its own legal framework.

Table 2. Major issues in the field of forensic accounting for the year of 2014

<table>
<thead>
<tr>
<th>Major Issues</th>
<th>%</th>
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<tbody>
<tr>
<td>Electronic data analysis</td>
<td>25</td>
</tr>
<tr>
<td>Increased complexity and scrutiny in engagements</td>
<td>20</td>
</tr>
<tr>
<td>Competition and fee pressure</td>
<td>14</td>
</tr>
<tr>
<td>Regulatory changes</td>
<td>11</td>
</tr>
<tr>
<td>Attracting and retaining qualified staff</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>23</td>
</tr>
</tbody>
</table>

Source: The 2014 AICPA Survey on International Trends in Forensic and Valuation Services
Table 3. Major issues in the field of forensic accounting for the year of 2011

<table>
<thead>
<tr>
<th>Major Issues</th>
<th>%</th>
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<tbody>
<tr>
<td>Attracting and retaining qualified staff</td>
<td>25</td>
</tr>
<tr>
<td>Keeping abreast of regulatory changes</td>
<td>14</td>
</tr>
<tr>
<td>The economy</td>
<td>13</td>
</tr>
<tr>
<td>Competition and fee pressure</td>
<td>11</td>
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</tbody>
</table>

Source: The 2014 AICPA Survey on International Trends in Forensic and Valuation Services

According to the AICPA, among other types of occupational fraud, only 3% of the organizations experienced financial statement misrepresentation in the previous years. Concurrently, according to ACFE study, this category of occupational fraud also represents the least frequent one, but on the other hand, median loss for this type of fraud is the highest, as we have already mentioned in this paper.

As presented in the pie chart above, an overstatement of accounts receivable, inventory, securities or other assets are most likely to be affected by fraud activities, according to the AICPA. This does not come as a surprise, having in mind that manipulations of current assets, especially accounts receivables and inventories attained a high level of fraud, since they are very suitable for artificial inflating. Some of the examples could include failing to write down obsolete inventory, uncollectable accounts; changing between inventory reporting methods (FIFO, LIFO); improper or fraudulent inventory capitalization; transferring a security from held to maturity to trading/available for sale; and other manipulations that would permit the recognition of gains that otherwise would not be recognized. Although, according to the AICPA research, improper revenue recognition is the second most common type of financial statement misrepresentations, it is a very frequently used form of earning management. This technique was also used by many companies, known for accounting scandals and financial corruption such as Cendant Corporation, Enron, K-Mart, Xerox and other.

Chart 1. The most common types of Financial Statement Misrepresentation

Source: The 2014 AICPA Survey on International Trends in Forensic and Valuation Services

Furthermore, the study showed that twenty-nine percent of respondents believed that valuation of assets carried out at fair value would be the most prevalent financial statement misrepresentation issue in the next two to five years. Another 26% cited inadequate disclosures of material transactions and fraud, 23% tapped revenue recognition and 14% the treatment of off-balance-sheet assets and liabilities. Seventy-four percent expected that allegations of inadequate control over financial reporting would be a prevalent issue in conjunction with other issues in the next two to five years, while 14% saw it as a prevalent standalone issue.

When it comes to the detection method of fraud, it seems that the best detectors of financial fraud activities are actually employees. Despite the possibility of them being the perpetrators, the research shows that owners and executives are more likely to commit fraud as well as median damage appears to be ten times greater than in the case of employees committing fraud, according to the ACFE. The results conducted in the year of 2016 show that the median damage caused by executives or owners in 114 countries was $703,000, while the median damage caused by employees was $65,000. This could be explained by the fact that executives, due to their authoritative positions and access to different valuable information have a greater opportunity to embezzle and misappropriate more significant and valuable assets.


In an environment of increasing scrutiny of how companies are governed and tightening economic conditions as well, there is heightened sensitivity to fraud, more efforts to detect, prevent it, but also to take legal action against the fraudsters. Based on previously analyzed data, it is evident that the growing need for a forensic accounting profession is necessary and reasonable. Moreover, according to the Security and Exchange Commission (SEC), in the United States of America only, the presence of forensic accountants is currently 26,074 out of total of 5,162 public businesses.\(^\text{17}\) Survey conducted by the AICPA shows demand for forensic and valuation services and strong prospects for their future. A total of 76% of forensic and 54% of valuation respondents expected their practices to grow with the majority expecting growth of between 10% and 50% over the next two to five years.\(^\text{18}\) At the same time, commercial forensic accounting is also an area that has been developing rapidly, enabling evaluation of company’s current financial performances.\(^\text{19}\) In this manner, commercial forensic accounting represents a preventive tool that could minimize risks of possible fraud activities, and at the same time indicates red flags and weaknesses of internal control within organization. Forensic accounting, whether traditional or commercial, represents the highest level of insurance in detecting financial fraud. Thus, in an era of increasingly risky business environment, it is expected that future researches in this area will emphasize the importance of the forensic accounting profession even more.

**CONCLUSION**

The goal of forensic accounting is to acquire evidence, in the case of suspicion of certain fraud activities within a company, which can later be used for the purposes of judicial proceedings. Moreover, it represents the application of investigative and analytical skills for the purpose of resolving financial issues in a manner that meets standards required by courts of law. The studies, conducted by AICPA and ACFE, indubitably indicate the need of profession such as forensic accounting, as a consequence of the vast number of occupational fraud, as well as criminal offences against the economy. All parties interested in growth and development of their businesses can benefit from forensic accounting, which represents a powerful tool for preventing and detecting fraud activities. In this manner, the role of forensic accounting could be twofold. As a preventive tool, it could help to indicate red flags within organization, weaknesses of internal controls and all sensitive areas that could potentially present opportunity for fraudsters to commit the fraud. On the other hand, if the fraud has already been committed, forensic accounting applies different types of investigation in order to provide the evidence that could confirm or refute potential fraud activities. Although the implementation of forensic accounting is still complex and high-priced, there is no doubt that it is of significant value for the entire economy, as well as that increasing demand for this profession can be expected in the future.

**LITERATURE**


