

IMPACT OF FORENSIC ACCOUNTING ON FRAUD DETECTION

Ashwin R¹

Parasuram Praveen M²

Shashank Subbaiah KK³

B.Com F&A, Department of Professional Studies, Christ University, Karnataka, India

Asra Khan⁴

Assistant Process Associate, McKinsey & Co.

ABSTRACT

The paper seeks to explain the impact of forensic accounting on various industries. The paper mainly explains the impact of forensic accounting on stock prices of the company. Stock prices of 5 companies, namely, Health South, Enron, TYCO International, Freddie Mac and WorldCom has been studied. This paper examines the extreme impact forensic accounting has on the position and value of the company.

Keywords: *Forensic Accounting, Industries, Stock prices, Company*

INTRODUCTION

Forensic accounting is a rapidly becoming prominent in accounting and legal communities. It uses accounting, auditing and investigate skills. Forensic accountants look beyond just the numbers in the financial statements. They analyze the financials and find sufficient and appropriate information to be presented in the court room. They interpret complex financial matters and help us understand the business reality behind numbers. Forensic accountants are employed in various sectors and fields these days, they interpret the financials of a company to find out any unfair means of presentation. Forensic accounting is rapidly improving and gaining status in the world. Just like how the discovery of frauds through fingerprints and DNA were a breakthrough in the 19th and 20th centuries, forensic accounting will be the same to the 21st century. Forensic accounting goes by the fact that 'Things are not what you think they are'. Forensic accounting and fraud auditing are not synonymous, forensic accounting requires an

individual to have proper legal knowledge in addition to accounting language. Unlike an auditor, a forensic accountant doesn't limit the scope of the audit based on materiality, samples and integrity of management and thus it is highly time consuming. Forensic accounting has helped in giving important clues to solve cases too. An important element in forensic accounting is behavioral concepts, some frauds cannot be solely detected through data driven approaches. Fraud auditing is like an iceberg with many of the behavioral, covert aspects of the fraud below the water line. The aspects below the surface can be extremely important and this is where forensic accounting plays a major role.

REVIEW OF LITERATURE

The increase in financial frauds has brought forensic accounting into limelight. The combination of forensic science and accounting has helped to track many frauds, crimes and even terrorist attack funding. The failure of corporate structures, lack of internal control, poor corporate governance, fraudulent financial statements have led to the rise of forensic accounting. Forensic accounting were initially used by agencies like FBI, CIA and IRS but currently they are very prominent because they can play a vital role in coordinating company efforts to achieve a cohesive policy of ethical behavior within the organization. Forensic accountants should have a wide range of skills and knowledge, from financial accounting, internal control systems, law, investigating skills, interpersonal skills (Madan Lal Bhasin, 2016)

In a developing country like Nigeria, the upsurge in financial accounting fraud is a bane. The alarming increase in the number of fraud activities and the complexity of modern day banking with large volume data has made manual auditing processes nearly ineffective. Centre for Forensic Studies (2010) report in Nigeria states that if well applied, forensic accounting could be used to reverse the leakages that cause corporate failures. Proactive forensic accounting seeks out errors and deviant transactions before they crystalize into fraud. Financial fraud had become a normal way of life in Nigeria. Financial frauds in Nigeria have led to losses worth 1 trillion naira for commercial banks. Gathering information admissible in the court was tough since the laws were not up to date, this was one of the hugest challenge faced. A survey conducted has shown full support of the respondents towards the implementation of forensic accounting (Kennedy

Prince Modugu , Dr. J. O. Anyaduba,2013)

Traditional auditing focuses on errors while forensic accounting focuses on fraud. Forensic practice was not recognized as a separate accounting practice area from auditing at one time. Over the decades, auditing separated itself from fraud detection. As that occurred, the forensic practice began to developed and provide fraud investigation and litigation services. As forensic practices followed its own separate path, the services provided changed into those of an investigative nature. Today, with the rate of crimes against every business, the nature of forensic practice is about to expand. This paper reviews the changes that have occurred in forensics in the past, and makes predictions about future changes coming to this practice (Dalhi Gray, 2008)

This research studies the impact of forensic audit on corporate fraud in Nigeria. The main aim of this particular research paper is to identify and examine the relationship between forensic audit and corporate fraud in general. Both primary and secondary data is collected and is used in this study. The primary data is collected by way of distribution of questionnaires to collect sufficient data, while the secondary data was collected from websites, journals and magazines. The collected data were analyzed using IBM SPSS Statistics 21ordinary least square (OLS) regression technique and various other statistical analyses. This study's result is that the frequent utilization of forensic audit services will help in the detection to a greater extent, and the prevention as well as reduction of incidences of fraud in any business units or organization. Thus, it could be concluded that the forensic audit is deemed to be an efficient and effective tool against corporate frauds. This study suggests that the forensic audit must be made statutory in all organizations and business units (A. O. Enofe, P. Omagbon and F. I. Ehigiator, 2015)

With India being positioned as the 88th most degenerated country, the requirement for measurable forensic professionals has increased significantly. Owojori states that the failure of statutory audit to prevent and reduce mis-appropriation of corporate fund and increase in corporate crime has led to the want of forensic accountants. A study conducted Kessler international showed that 39% of organizations have considered the need for a forensic accountant. . According to AICPA (1992) independent auditor has to express his opinion on the fairness in all respect of financial position, results of operation and its cash flow in controlling with GAAP. However, modern organized corporate frauds are sophisticated and most of the issues are beyond the reach of an auditor. The need to respond to this changing criminal threat

has aroused the call for forensic accounting (By Owojori AA and T.O Asaolu, 2008)

STATEMENT OF PROBLEM

There has been a greater increase in financial crime, mismanagement and misappropriation of public funds in today's world. Many arrests have been made, however, the number of prosecutions is not viewed the same way as such. This could be associated with lack of usage of forensic accounting skills in the investigation process or is it that the awareness of the use and application of forensic accounting in investigation process is limited. It is because of this that this research intends to study the place of forensic accounting in fraud detection and prevention and the level of awareness created on the use of forensic accounting in fraud detection. Stringent laws and policies are being violated by top entities for their own personal gain by ignoring the effects of discovery of the same.

RESEARCH OBJECTIVE

This research is conducted to study the impact of forensic accounting on fraud detection. The specific objectives are to:

- 1) Find out the manner in which forensic accounting affect fraud detection.
- 2) Find out its impact on the performance of the company

SOURCES OF DATA

Secondary data has been mainly used for this research. The stock prices and financials of the companies have been obtained from a variety of web sources.

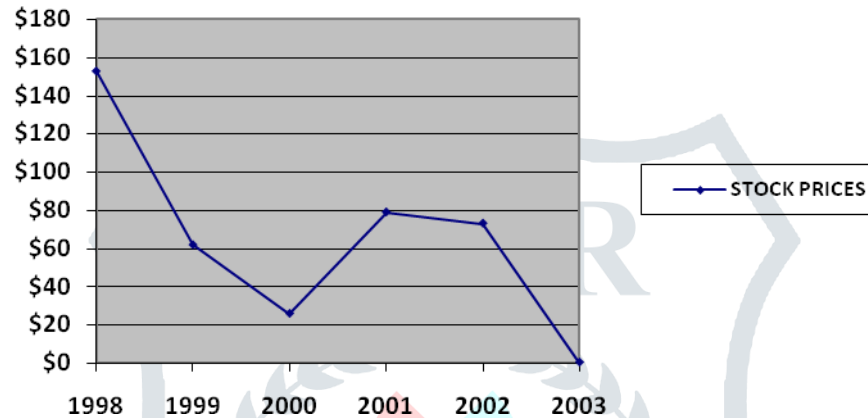
LIMITATIONS

All the secondary data have been taken from web sources and thus there isn't complete reliability. Few of the company's came into complete shutdown after they have been investigated by forensic accountants and thus the impact post the fraud detection cannot be analyzed properly.

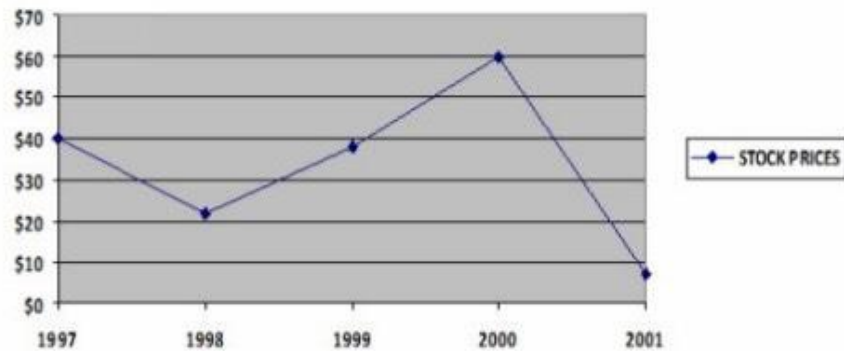
DATA ANALYSIS

Health South is an establishment having rehabilitation hospitals across USA. In 2003 forensic accountants bust open the real truth behind their financials, they had overvalued their assets by

800 million dollars and overstated their income by 1.4 billion. All of a sudden, a company scaling heights was in deep debts. Once the fraud was discovered, the company lost its reputation. Stock prices fell by 97% to a all-time low of \$.4003. The stock prices which were at a price of \$134 before the discovery, still hasn't been valued over \$77 till date. The company is still recovering and has done well only since 2015.

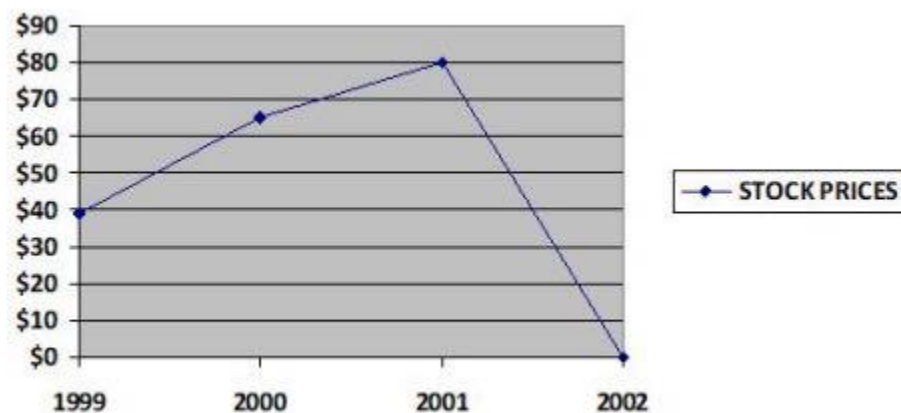


Tyco International was a security frameworks organization fused in the Republic of Ireland, with operational base camp in Princeton, New Jersey, United States. Tyco International was made out of two noteworthy business sections: Security Solutions and Fire Protection. They overstated their profits by \$382 million. Along with this, they had manipulated accounts in various manners. They stated \$150,000 as charity but when the same was investigated, it didn't qualify as charity. Various such similar frauds took place. The stock prices of TYCO international were as high as \$60 in the year 2002 before the fraud discovery. After the investigation procedures, the stock prices fell below \$9. The huge involvement of the management in the fraud had a very bad impact on the company. Though the company is still doing well, the investigation helped to remove unfair practices in a huge company.

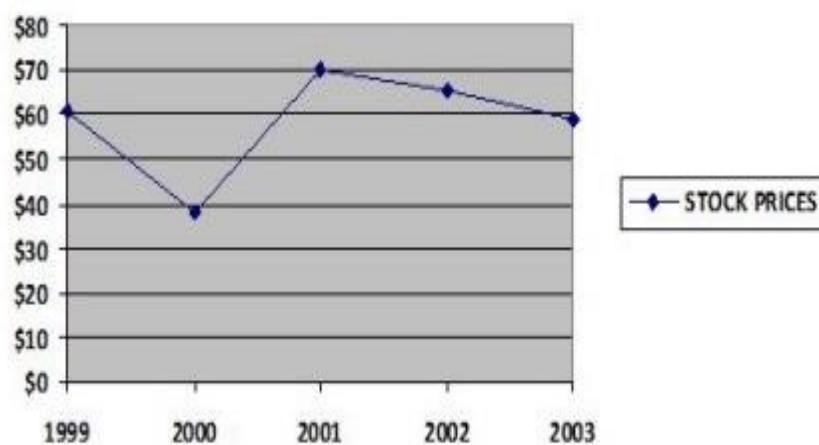


Enron was known as the darling of Wall Street. The company was doing very well and the stock prices hit a high of \$90.56. They used special purpose vehicles to hide their huge debts and toxic assets. The president warned the company of the future ill effects but the CEO didn't care. Once the company's financials came under scrutiny, the company became bankrupt. The stock prices fell down to \$0.26 and investors had a return of -99%. Forensic accounting ended a company so big in no time. The table below shows the extent to which the company's financials were altered.

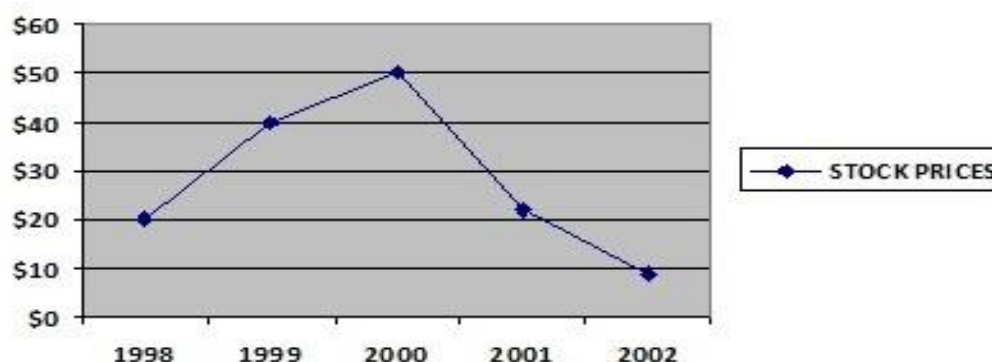
Items	Reported Figures	Actual Figures	Percentage of change
Cash From Operations	\$3010	\$-153.9	-105%
Debt	\$10,229	\$22,060	116%
Earnings	\$2,492	\$1793	-28%
Interest Expense	\$944	\$1567	66%



Freddie Mac is a federally chartered mortgage financing giant. They misstated their earnings by \$5 billion. They overstated their earnings by \$1 billion in the year 2001 and understated their earnings by \$6 billion between the years 2000-2002. They gave \$2.3M to Republican Party and \$1.7M to the Democratic party. Their stock prices didn't vary much despite their fraud discovery and the company's shares continued to do well.



WorldCom is a company dealing with telecommunications. Their improper accounting practices overstated profit by \$3.2B dollars from year 1999-2002. The company had also reported \$3.8 B dollars of expense as capital investments. WorldCom manipulated the reserves to an extent of \$3.3 Billion. This has led to an improper of operating costs which has in turn inflated the profits of the company. The company's peak stock price was \$64.5 and posts this scandal; it fell down to 83 cents.



Findings and Interpretation

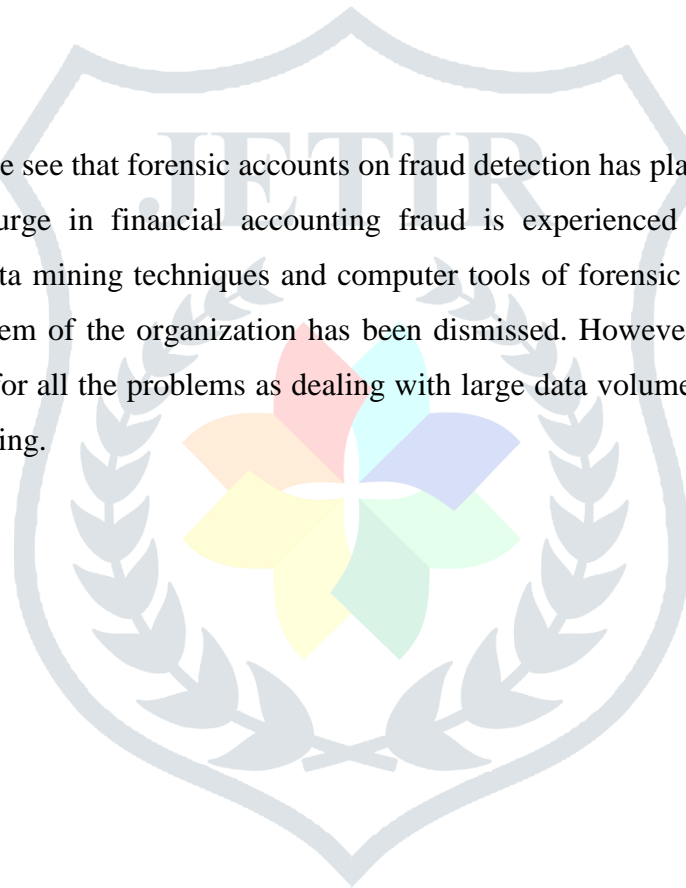
- The company's mentioned above were carrying out normal accounting techniques and policies and thus fraudulent activities took place with ease. Once forensic accounting was brought into practice in the firms, the real financials came out.
- Tracing the routes of the funds, applying investigative skills and using audit techniques played a very vital role in detecting the fraudulent activities that the companies have been accused of.
- The more the financial misrepresentation was being uncovered the more the accountants were pushed to pressure of finding the misrepresentation.
- If not for the techniques and procedures used in Forensic Accounting, the scandals would not have come to light with normal traditional techniques and procedures. For example, Enron would still be the darling of Wall Street, fooling so many investors and the government with their fake financials, this would create a black hole in the economy.
- The company's altered financials not only affected the shareholders but it affected the employees, its dealers and every other person and entity associated with the company.
- Forensic Accounting creates an environment of caution in the organizations; the fear of the company being exposed and its ill effects makes the top officials refraining from carrying out fraudulent accounting activities.
- In recent times, with the increase in white collar crimes, forensic accounting has been used in a lot of entities.
- The impact forensic accounting has had on the stock prices of the companies is very

significant. Companies having the highest stock prices have seen their stock price value reduce to the lowest figures. This in turn has a good impact on the stock market on the whole and helps in stabilizing the stock market.

- On the other hand , scandals in the accounting world have been on a low ,fearing the ill effects of fraud discovery , companies are showing a true and fair view of their financials.
- The stocks of Freddie Mac remained to have stable prices , they paid all their fines on time and thus they maintained their reputation and also their accounts according to law.

CONCLUSION

Through our study, we see that forensic accounts on fraud detection has played a great role in our economy as an upsurge in financial accounting fraud is experienced in current economic scenario. Through data mining techniques and computer tools of forensic accounting, failure of internal auditing system of the organization has been dismissed. However, forensic accounting may not be solution for all the problems as dealing with large data volumes and complexities of financial are challenging.



BIBLIOGRAPHY

1. Modugu, k. (2013). Forensic Accounting and Financial Fraud in Nigeria: An Empirical Approach Retrieved from http://ijbssnet.com/journals/Vol_4_No_8_Special_Issue_July_2013/28.pdf
2. Madan Lal Bhasin , 2016. Contribution of Forensic Accounting to Corporate Governance: An Exploratory Study of an Asian Country. Retrieved from <http://medwelljournals.com/abstract/?doi=ibm.2016.479.492>
3. Enofe,OmagbonandEhighor,2015. Retrieved from https://s3.amazonaws.com/academia.edu.documents/42385288/FORENSIC_AUDIT_AND_CORPORATE_FRAUD.pdf?AWSAccessKeyId=AKIAIWOWYYGZ2Y53UL3A&Expires=1537979206&Signature=BdUvP0IUvBvidpSACvkS1vzab5Q%3D&response-content-disposition=inline%3B%20filename%3DFORENSIC_AUDIT_AND_CORPORATE_FR_AUD.pdf
4. Owojori and asaolu , 2016 The role of forensic accounting in solving the vexed problem of corporate world. (2016). Retrieved from https://www.researchgate.net/publication/292566948_The_role_of_forensic_accounting_in_solving_the_vexed_problem_of_corporate_world