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Forensic Accounting – What you need to know

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Are your client's losses due to a downturn in the economy, obsolete products, bad management or fraud? These are the questions that Board of Directors, upper management, investors, external auditors, and attorneys need to ask if there are observed abnormalities or unexplained losses in a company's financial statements.

In situations where fraud is suspected, utilizing the services of a forensic accountant is prudent.

Simply defined as the intersection of accounting and the law, forensic accounting is the application of financial principles and theories to the facts at issue in a legal dispute. It consists of two primary functions:

1) Litigation Advisory Services, which recognize the role of the forensic accounting professional as an expert or consultant.
2) Investigative Services, which makes use of the forensic accounting professional's skills and may or may not lead to courtroom testimony.

Forensic accounting professionals provide technical, educational, functional, and industry-specific services to financial statement fraud cases.

Questions often asked: What is the difference between external auditors and forensic accountants? Isn't it the external auditor's job to uncover the fraud? Why can't the auditors provide absolute assurance that no fraud is occurring?

External auditors cannot guarantee that the financial statement they audited are entirely free of material misstatement. Auditors cannot provide absolute assurance for two reasons:

1) The nature of audit evidence – Auditors test only selected data. They do not audit all subsidiaries, divisions, accounts or transactions as it is not economically possible. Auditors make judgements about the areas to be audited.
2) The characteristics of fraud, particularly fraud based on collusion among management or falsified documents.

Forensic accounting and traditional auditing are interrelated but have uniquely-distinct and separate characteristics. The commonalities between auditing and forensic accounting include:

1) Knowledge of the industry and the company, including its business practices and processes
2) Knowledge of the generally accepted accounting principles
3) Interpretation of business documents and records
4) Independence and objectivity

Investors and the general public need to understand that Audits are not the same as forensic accounting investigations. Statement on Auditing Standards No. 1 states, *the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. This statement establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in audit of financial statements conducted in accordance with generally accepted auditing standards.*

Forensic accountants on the other hand, provide more investigative services. The scope is more defined depending on the case requirements. In addition, forensic accountants are consistently evaluating and interpreting documents relating to the assignment and utilizing specific financial forensic tools and techniques as part of their analysis and ultimate conclusion.

Forensic accountants must have three major skill sets:

1) Technical competence – Requisite accounting and auditing skills as well as a knowledge in certain areas of law and research.

2) Investigative – Knowledge in collecting, analyzing and evaluating of evidential matter and critical thinking ability.

3) Communication skills (verbal and written) – The forensic accountant must be able to communicate and present their findings in a way that is easy to understand and supported by facts.

One skill-set that usually clearly separates forensic accountants from traditional accountants or auditors is the level of professional skepticism. Professional skepticism is the ability to recognize that a fraud may be present, and having the attitude that includes a questioning mind and critical assessment of the evidence.

Fraud vs. Error?

Auditing standards state that the main difference between fraud and error is intent. Errors are unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may include:

- Mistakes in gathering or processing data from which financial statements are prepared.
- Unreasonable accounting estimates arising from an oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles.

Fraud on the other hand includes four essential elements:

1) A materially false statement is made.

2) There is knowledge that the statement was false when it happened.

3) There was reliance on the false statement by the third parties and/or the victim(s).

4) Damages resulting from the third party or victim’s reliance on the false statements.

Three major categories of fraud are as follows:

1) ***Asset misappropriation*** which involves the theft or misuse of a company's assets. Examples include stealing inventory, skimming cash or payroll fraud.

2) ***Corruption*** which entails abuse of influence to achieve a desired result such as receiving illegal kickbacks or bribes.

3) ***Financial statement fraud*** which involves the intentional misrepresentation of financial and non-financial information to mislead those relying on the financial statements to make economic and management decisions. Massive financial statement fraud includes inappropriate or unauthorized journal entries or unsubstantiated adjustments of amounts reported in the financial statements.

One of the basic investigative techniques utilized by a forensic accountant is identifying "Red Flags." Red Flags are defined as a warning signal or something that demands attention or provokes a negative reaction.

Red Flags may be divided into the following categories: (1) accounting anomalies, (2) internal control weaknesses, (3) identified analytical anomalies where non-financial data does not correlate with the financial data (i.e., substantial losses in a booming economy), (4) observed unusual behaviors by management/employees, and (6) whistleblower tips.

Beside observing Red Flags, the forensic accountant also needs to understand the fraud risks that might be present in the company being analyzed. Fraud risk factors generally fall into three categories:

1) Motivational – Is management focused on short term results or personal gain?

2) Situational – Is there ample opportunity for fraud?

3) Behavioral – Is there a company culture for a high tolerance of risk?

As mentioned above, the biggest difference between fraud and error is intent. Intent must be grounded in the evidence. In a fraud case, the challenge is that short of a confession, evidence of intent tends to be circumstantial. The elements of fraud include the act (e.g., fraud act, tort, breach of contract), the concealment (hiding the act or masking it to look like something different) and the conversion (the benefit to the perpetrator).

In a forensic accounting examination, evidence is usually gathered in a manner that moves from the general to the specific. In the case of financial statement fraud, the forensic accountant starts with the suspected perpetrator. This is because the forensic accountant is assuming the person knowingly created false financial statements.

The power of using non-financial data to corroborate financial information cannot be understated. What is non-financial data? It is data from any source outside of the financial reporting system that can be used to generate an alternative view of the business operation. Non-financial data may include payroll hours, employee records, complaints, shipping records and dates.

Before any forensic accounting examination begins, the forensic accountant needs predication. Predication is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred, is occurring, and/or will occur. An anonymous tip or complaint is a common method for uncovering fraud and is generally considered sufficient predication. Mere suspicion, without any underlying circumstantial evidence, is not a sufficient basis for conducting a forensic accounting examination.

Since our founding in 1988, Empire Valuation Consultants has grown into one of the nation's leading and most respected independent valuation and forensic accounting firms, with a staff of over 80 employees in New York City, Long Island, Boston, Rochester, West Hartford, and San Francisco. We bring excellence and integrity to every engagement through our team of highly skilled individuals who are among the finest our industry has to offer. Our valuation and economic damage reports are prepared by certified fraud examiners and senior accredited valuation experts holding one or more of the following professional credentials: CFA, ASA, IA, CPA, and ABV. We provide valuation and litigation support to attorneys, accountants, business owners, private equity and hedge funds, commercial bankers, investment bankers, trust departments, insurance agents, and financial planners, among others.

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