

An Insight into Forensic Accounting

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Abstract

Forensic accounting comes under the category of relatively new profession that utilizes various methodologies and implementation of various techniques. This field of forensic science is structured and constructed by keeping in mind the world's economy, society and legislation. With the increasing number in financial accounting deceptions and frauds in the global economy, forensic accounting has become the field tagged as savior for the safety for the financial administration process of academic, research and commercial institutions. The total combination of accounting, auditing and investigative skills signify this specific field. Just as forensic science has been implemented to capture the criminals for long, forensic accounting is fast emerging in the arena of corporate accounting frauds to play a similar role. The purpose of this study is to develop an innovative approach of combating economic crime using the forensic accounting techniques by reviewing the previous studies made on this field of forensic science.

Keywords: Forensic Accounting, economy, frauds, global economy, investigative skills, economic crime, forensic science etc.

Introduction

Forensic accounting is the combination of auditing, accounting & investigative technique, which is used to discover various types of white-collar crimes related to financial frauds. Investigation is the vital part of forensic accounting and only applied when the event or transaction beclouded. It is carried out when laps have been established to determine the reason for the action, including the extent of damage if any. It can be referred as a detailed verification and clarification of doubt above a transaction or event. It is the search and exam of events to determine. The hidden unique or complex facts surrounding the event, deliberate search and review of record in accordance with the laid down and agreed policies in

order to determine it and why the keeping of record resulted in a gap and the responsible person [3-7].

Literature Studies

Bhasin concluded that forensic accounting in India has come to limelight only recently due to rapid increase in white-collar crimes and the belief that our law enforcement agencies do not have sufficient expertise or the time needed to uncover frauds. A large global accounting firm believes the market is sufficiently large to support an independent unit devoted strictly to 'forensic' accounting. All of the larger accounting firms, as well as, many medium-sized and boutique firms have recently created forensic accounting departments.

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Digabriele surveyed practitioners, academics, and users of forensic accounting services throughout the United States to determine whether there are differences in views of the relevant skills suggested in the practitioner literature. The results indicate that practitioners and academics agree that critical thinking, unstructured problem solving, investigative flexibility, analytical proficiency, and legal knowledge are important skills of forensic accountants.

Dhar & Sarkar concluded that forensic accounting is one of the fastest growing professions. But beyond a cursory glance one recognizes that while the title is new, what the job intends to achieve is nothing new. The job performed is not unlike what was done in the name of investigation previously. There is one version of how the name 'forensic accountant' developed.

Huber evaluated the feasibility of alternative solutions. It concludes that the most realistic alternative is for government regulation of forensic accounting in the form of legislation at the state level. The least intrusive approach is to limit the use of titles that include the use of any combination of the words "certified/chartered," "financial/ forensic/fraud," and "accountant/auditor/examiner," to those who obtain their certifications from corporations that meet minimum standards set by the state regarding disclosure of legal status, publishing financial statements, qualifications of corporate board of directors and officers, and adoption and enforcement of a Code of Ethics and Standards of Practice.

Modugu & Anyaduba found that there is significant agreement amongst stakeholders on the effectiveness of forensic accounting in fraud control, improving financial reporting and internal control. Accountants should therefore be alert to potential fraud and other illegal activities while performing their duties. They can also be made to provide significant assistance in preventing, investigating and resolving such issues.

Popoola *et al.*, has discussed forensic accountant and auditor capability (i.e., mindset and skills) and forensic accountant and auditor competence (i.e., TPFRA) towards a reduction in fraud in the Malaysian public sector.

Bhasin, studied the potential practitioners,

academics and users agree that critical thinking, written, oral communication, legal knowledge, auditing skills, deductive analysis, investigative flexibility, analytical proficiency and structured problem solving are the most important skills for a forensic accountant.

Atağan & Kavak, concluded that there are many reasons for frauds in companies. Some of these are reasons such as tax evasion, false representation of companies' financial status, loaning big amounts from the banks, raising the price of the company shares. Although measures are taken, they are not enough; because it is the human intelligence both makes the fraud, and improves the deterrence measure against the fraud. New approaches are needed in this context.

Catania, spreaded awareness and conferred recognition to a mostly forgotten individual: Mr. Frank John Wilson, who was quintessential in the development of techniques used in the field of forensic accounting

Hitchcock, thoroughly explores fraud and the forensic accounting profession. It details the education, training, and careers of forensic accountants; and why demand for this profession has suddenly spiked. The necessary skills of forensic accountants and why these skills are valuable is explored; a need for better education and training is also proposed. It also details popular forensic accounting methods and how these may be used to detect fraud. This thesis explains several fraud schemes and famous frauds that were contributors to the growing demand of forensic accountants. The fraud triangle and other contributing factors are explored.

Akinbowale *et al.*, analysed the literature review indicated that one of the drawbacks, which has continued to mitigate the implementation of forensic accounting as a tool for combating fraud is lack of a suitable framework. This was the major focal point of this work, which produced two simplified conceptual models suitable for effective fraud mitigation.

Rehman & Hashim measured forensic accounting's (FA) impact on sustainable corporate governance (SCG) within Omani public listed companies. Beyond merely cataloging the latest criminal innovations and SCG problems, this paper

offers a path forward to overcome the myriad threats that can harm the organization and society. FA and SCG can achieve, anticipate and prevent tomorrow's fraud today before organizations reach the point of no return.

History of Forensic Accounting

Forensic Accounting has taken many great leaps of growth in recent history. The Accounting industry has gradually called for more and more Forensic Accountants. It is predicted that growth of the industry, based on the amount of jobs, will reach 6.7% for the years between 2013 and 2018. Like any other job, Forensic Accounting has evolved with time. The industry has been affected by changes in technology, society, and the economy. Frank Wilson first defined forensic accounting in the 1930s after working on a financial case against American gangster and businessman Al Capone. However, this highly complex accountancy skill might have been around for much longer than its formal definition. In fact, it's thought that forensic accounting has even been around since the time of ancient Egyptians. During Ancient Egypt, accountants were hired to account for the Pharaoh's assets and experts believe that ancient Egyptian methods of accounting have many parallels with today's modern-day forensic accounting. The world of forensic accounting has been developing for the past 70 years. Some credit the beginning of the understanding of fraud as a subject of scientific study to the 1934 work of Donald Cressey and Edwin Southland, who coauthored *Principles of Criminology*. The name Forensic Accounting wasn't even coined until 1946 implying that this specialty careerpath was not especially common. Even the first Forensic Accounting book did not come out until 1982. The popularity and need for the services Forensic Accountants provide has steadily and more rapidly grown in the past few decades. In the 1960's the FBI employed over 700 Special Agent Accountants. They have maintained a similar level of employment in their Financial Crimes Section to this day. They investigate cases of financial fraud, crimes over the Internet, money laundering, and many other economic crimes. Six weeks of intense training are required before anyone starts their job with the FBI Financial Crimes team. As most Forensic Accountants must, they testify to any findings in court on a regular

basis and are often broken up into investigation and litigation support. However, the two go hand in hand^[10]. Mr. Frank John Wilson, who was quintessential in the development of techniques used in the field of forensic accounting today is known as the father of forensic accounting^[12].

The Concept of Fraud Triangle and Forensic Accounting

According to the dictionary definition of the term "FORENSIC" means belonging to, has application with respect to the court of law and Forensic accounting is sometimes referred to as the use of accounting knowledge and investigative skills for the purpose of ascertaining, recording, evaluating, interpreting, and communicating useful information on complex business issues so as to be able to resolve legal issues^[1]. The word "FRAUD" comprises of performances of activities including theft, corruption, conspiracy, extortion, bribery etc. So, this term fraud plays the most significant role in the whole forensic accounting field. The three components that make fraud possible are *opportunity, attitude, and incentives/pressures*. Incentives and pressures give employees and management a reason to commit fraud. Incentives include financial interests and bonuses that may be contingent on company performance^[13].

The Forensic Accounting Process

The forensic accounting process shares similarity with the auditing process. Forensic accounting comprises of the elements of the auditing process. The differences are that the auditors search for the misrepresentation is accidental or intentional. The first steps if the forensic accounting investigation is meet the client and accepts the job. It is very important to have the required skills for the specific job according to GAAS (Generally accepted auditing standards). After accepting the job, the formation of the initial plan for the investigation is required. The basic plan of the investigation will help the investigator to draw an outline of the case. He will consider the client and its surrounding environment which will also include the non-financial information. The implementation of the analytical procedure will help the investigator for the quick calculations pertaining to financial statement data. Through this process includes ratios such as debt to equity ratio and return on sales. He

will pay attention to the internal controls and other deficiencies that make the fraud more likely. Then the detailed plan will be made and implemented. After the development of the detailed investigative plan, the forensic accountant must carry out through out the whole investigation. Gathering and analyzing of the evidence is the next step of the investigative process. The FA will focus heavily on the areas affected by weak internal controls. Observed red flags should be taken under consideration by the FA. It is important to keep all the records of the investigation to maintain the chain custody and for testifying in court along with providing evidences. After analysis of the evidence the report should be formulated along with advice about preventive and corrective actions to prevent issues.

Analytical Procedures and Ratio Analysis

Analytical procedures are performed by the forensic accountants for the detection of frauds and measuring the amount of exploitation. The most common way for the detection of the fraud is RATIO ANALYSIS. There are 6 categories of ratios in forensic accountancy.

Direct/Transaction Method

The Direct Method of forensic accounting is also known as the Transaction Method. This method involves examining canceled checks and invoices, contracts, agreements and public records and notices. The accountant will also likely interview management and employees; this gives a better understanding of the accounting process and where there is potential for fraud. Examining all relevant documents ensures that the investigation is conducted thoroughly. The forensic accountant will also prepare a working statement of cash flows to better understand the inflows and outflows of cash; and where there may be suspicious gaps or unknown transactions.

Cash T Method

The Cash T Method is conducted by comparing the amount of cash received to the amount of cash spent. The purpose of this method is to determine if a company or individual had understated income. This method is conducted by listing all known sources and uses of cash. It is important to remember that this

method only considers cash transactions. All cash receipts are listed as debits; and all cash expenditures are listed as credits. This method is useful when the forensic accountant can accurately determine personal expenses. After determining all cash receipts and expenditures and totaling them together, the forensic accountant can calculate unidentified income by subtracting receipts from expenditures.

$$\begin{aligned} &\text{Cash Expenditures} - \text{Cash Receipts} \\ &= \text{Unidentified Income} \end{aligned}$$

If this equation results in a zero balance, then there is no unidentified income and it is unlikely that fraud has occurred.

Source and Application of Funds Method

The Source and Application of Funds Method is similar to the Cash T Method. This method examines the amount spent on lifestyle versus assets and investments. This is another useful way to determine the net income and true worth of an individual or company. This method does not only consider cash transactions; it also considers "changes in assets and liabilities." Sources of cash include "decreases in assets, increases in liabilities or nontaxable receipts" and applications of cash include "increases in assets, decreases in liabilities and nondeductible expenses" ("Cash Intensive"). Because beginning and ending account balances are required to perform this method, it is more time-consuming than the Cash T method. It is much easier to apply this method if a statement of assets and liabilities (or a balance sheet) is available for use. After all sources and applications have been identified, total sources are subtracted from total applications to identify any understatement in adjusted gross income.

$$\begin{aligned} &\text{Cash Applications} - \text{Cash Sources} \\ &= \text{Understatement of Adjusted Gross Income} \end{aligned}$$

Net Worth Method

The Net Worth Method is conducted by subtracting net liabilities from net assets to determine net worth.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Net worth is then "compared to reported income over several periods" (Kent). Any strange differences

are a red flag to forensic accountants and should be investigated further. Forensic accountants may also calculate the change in net worth over several years to identify any discrepancies ("Cash Intensive").

$$\text{Change in Net Worth} = \text{Ending Net Worth} - \text{Beginning Net Worth}$$

This calculation can be tricky because fair market value is not always equal to GAAP (generally accepted accounting principles) value. The appraisal of assets may be subjective; and this may cause discrepancies between book value and true net worth. It is helpful to practice conservatism when using this method. This method is also useful in divorce proceedings. A forensic accountant may compare calculated net worth to reported net worth; large differences may be a sign of fraud.

Bank Deposit Method

The Bank Deposit Method is another way of comparing cash in to cash out. This method "compares the total deposits plus cash expenses minus nontaxable sources of income to the total receipts shown on the return" ("Cash Intensive"). This method is most useful when the taxpayer deposits all receipts in the bank and the forensic accountant is able to accurately determine expenses.

$$\text{Net Deposits} + \text{Undeposited Cash Expenditures} = \text{Total Receipts ("Cash Intensive")}$$

Net deposits equal all bank deposits minus nontaxable income. Nontaxable income may include pensions, gifts, loans, and any other nontaxable sources of income (regardless of whether deposited). Cash expenditures is calculated by subtracting checks written from total expenditures. Checks written can be determined by subtracting ending bank balances from beginning balances plus deposits.

$$\text{Checks Written} = \text{Beginning Bank Balances} + \text{Deposits} - \text{Ending Bank Balances}$$

Benford's Law

Benford's Law is "a statistical tool to determine whether the data under study shows any pattern signifying suspicious movement. Benford's Law may allow a forensic accountant to calculate the probability of fraud; but Benford's Law is not used to detect fraud.

Theory of Relative Size Factor

It detects unusual data, which may be due to either simple errors or frauds. It is based on the basic concept that each field in any transaction has a normal range and any data falling outside the range is unusual or an outlier and need to be further investigated. It is measured as the ratio of the largest number to the second largest number of a given set. Recently auditors are using Computer Assisted Auditing Tools (CAATS) to deal with huge data set and to process complex transactions thereby saving time and improving effectiveness^[11].

Applications of Forensic Accounting

Forensic accounting is implemented in preventing and investigations of business fraud. It is implemented for the detection of tax fraud. Misrepresentation of investments, commodities, and stocks is the most common white-collar crime. Forensic accounting is implemented for preventing these felonies. Detection of asset misappropriation or hidden assets. Detection and prevention of partnership and shareholding disputes. Forensic accountancy quantifies economic damages in road accidents and negligence cases. Forensic accountancy reviews insurance policies, coverage issues, claim settlements and calculate the potential losses. Investigates money laundering. Settles marital and family disputes regarding financial factors^[11].

Future of Forensic Accountancy in India

In India the formation of Serious Fraud Investigation Office (SIFO) is the landmark creation for the Forensic Accountants. Growing cybercrimes, failure of regulators to track the security scams, series of co-operative banks bursting-all are pinpointing the need of forensic accounting, irrespective of whether we understand the need or not. In the Indian context the Forensic Accountants are the most required in the wake of the growing frauds. The law enforcement officers are the experts of analyzing the fingerprints and the Narcotics but what about the digital evidence analysis. Very few know about it. It's a thrill of hunt. Maurice E. Peloubet who coined the term Forensic Accountant in 1946 said that the preparation of financial statements has some but not all of the characteristics of forensic accounting. This statement

is enough for the chartered accountants in India to foray in this field. It is new child on the block. Both CBI and CID cops do the forensic accounting work. Until recently there was no separate community in India. But now movement of India- forensic community is gathering the pace. The growing number of regulator and the administrative agencies will demand the services in the nature of forensic practice. Chartered Accountants are going to find themselves more involved in what is essentially a type of forensic practice. The changing nature of the Accounting and Auditing & assurance standards also confirms this. Nearly 40% of the top 100 American accounting firms are expanding their forensics and fraud services, according to Accounting Today. If this data is of some sense to Indian scenario then the day is not far away when forensic practice will contribute maximum to the total revenue of the Indian CA firm. Far from the humdrum stereotypic accountant your mind might have initially conjured, the forensic accounting professional is more of a private investigator with a financial sixth sense than the bookkeeper with a green eyeshade^[11].

Conclusion

The inclining demand in the field of current regulatory, legal and business environment should stimulate accounting programs to emphasize and embrace forensic accounting ^[9] Financial Fraud is real and has become prevalent in contemporary business environment. This trend needs to be arrested before it is too late. Forensic accounting is the new branch of accounting which has the sole aim of unearthing fraudulent activities within and outside an organization so far as the third party's action is in any way reflective on the activities of that organization ^[8] Future success for the profession depends, in part, on how the public perceives the ability of CPAs. New efforts in consulting, specialization and understanding global business practices and strategies are considered crucial. We go out into the niche market, examining our strengths first. We go where the action is, only then we know we can adequately service our clients and make money doing it^[2].

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