FINANCIAL INVESTIGATION AND FORENSIC ACCOUNTING

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CONTENTS

1. INTRODUCTION TO FORENSIC ACCOUNTING

1.1 AN OVERVIEW OF FORENSIC ACCOUNTING

While only relatively recently recognised as a separate discipline within the accounting profession, accountants and auditors have for many years been providing these services without using the label 'forensic accounting'.

From establishing a foothold in the emerging organised crime era in the United States in the late 1920s and 1930s, the discipline has grown over a period of more than 90 years into what it is today – a well-established and highly-specialised element of the broader accounting offering. The name 'forensic accountant' appears to have stuck.

The following table depicts the role of the forensic accountant in delivering their services across three broad categories of the forensic service offering (dispute advisory, fraud and corruption investigation, and forensic technology) and at two distinct levels (reactive and proactive).

	Dispute advisory	Fraud and corruption investigation	Forensic technology
Reactive	• Negligent act or omission • Breach of contract • Misleading and deceptive conduct • Trademark infringement • Business valuation	• Interview of suspects/ witnesses • Expert witness • Funds tracing/ recovery • Discovery • Computerised charting • Quantification of loss	• Data recovery • Analysis of complex data • Expert witness • Email monitoring
Proactive	• Dispute avoidance • Assistance in mediation	• High level of risk assessment • Detailed risk assessment • Fraud control planning • Integrity benchmarking	• Data mining • Penetration testing • Information systems risk assessment

Source: Dean Newlan.

KEY POINT

Note the move to investigative work by forensic accountants. Forensic accountants are now expected to conduct investigations from start to finish rather than, as was the case in former times, the forensic practitioner being presented with documents on which to base a quantification of the loss suffered due to fraud.

While the investigation of fraud and corruption is an important element of the forensic accountant's role, there are many other reasons a forensic accountant might be engaged. The list is extensive and includes:

- Management/governance failure;
- Internal control failure;

- Conflict of interest (where the conflict of interest falls short of the test that would render the conduct criminal);
- The reasons for corporate collapse including a consideration of the date of insolvency;
- Unauthorised leakage of commercially sensitive information;
- Theft of Intellectual Property;
- Complex reconciliation;
- Reconstruction of accounting records where records are missing;
- Failure to comply with regulatory requirements (for example those of the *Competition and Consumer Act* 2010);
- The multiple payment of invoices/overpayment of taxes, fees and other charges;
- Asset identification and location as a prelude to possible legal proceedings aimed at ensuring that any judgement will be satisfied;
- Workplace and Human Resources related investigations;
- Corporate intelligence aimed at determining who sits behind the organisation's business partners (suppliers and customers) or as a prelude to commercially transacting with another party …

This is just a small sample of the myriad engagements that are commonly referred to forensic accountants. Forensic work is incredibly varied and, frequently, very challenging.

1.2 DEFINITION OF 'FRAUD'

A large part of the forensic accountant's role will be the investigation of allegations of fraud, corruption and other illegal conduct by employees or persons otherwise connected with organisations (including directors, contractors and volunteers). It can also involve investigations into externally instigated fraud, corruption and other business crime.

In order to understand the forensic accountant's role in investigating and preventing internally or externally instigated fraud, we need to first define what is meant by the term 'fraud' – what does a lay (i.e. non-legally trained) person mean when they say 'a fraud has occurred' and how does that compare with the legal definition.

The following practical definition is a good starting point for a discussion of what **fraud** actually is:

DEFINITION

Dishonest activity causing actual or potential financial loss to any person or entity including theft of moneys or other property by employees or persons external to the entity and where deception is used at the time, immediately before or immediately following the activity. This also includes the deliberate falsification, concealment, destruction or use of falsified documentation used or intended for use for a normal business purpose or the improper use of information or position for personal financial benefit. The theft of property belonging to an entity by a person or persons internal to the entity but where deception is not used is also considered 'fraud' for the purposes of this Standard.

AS 8001:2008 *Fraud and Corruption Control*
Clause 1.7.8, Published by Standards Australia.

From a legal perspective, the expression 'fraud' is not generally used in crime focused legislation which tends to use words like 'theft', 'larceny', 'false pretences', 'obtaining property by deception' or 'false accounting'. The expression 'fraud' is therefore an umbrella term that is used to describe all of these and sometimes other criminal activity. We will be visiting many of these concepts during this course.

1.3 FRAUD AND CORRUPTION IN AUSTRALIA

There is much debate over the issue of whether fraud is a 'significant problem' in Australian business. At the end of the day, it probably depends on the business and the industry sector in which it operates. For major corporations, it is arguable that it is not a 'major problem' other than the relatively minor reputational damage that may result (which in any event is often quickly forgotten). Frauds valued at $20 million can be absorbed by most large publicly listed corporations but, even then, frauds of that value occur very infrequently.

Of more concern to large corporations is financial statement fraud, but again that is relatively rare and therefore the perception of business will be that it is not a major problem for them.

For SMEs and smaller corporations however, fraud can be, and often is, a major problem from the point of view that many of those corporate victims will not be able to recover from the losses. There are many examples of SMEs and smaller businesses that have been pushed into insolvency by a single fraud.

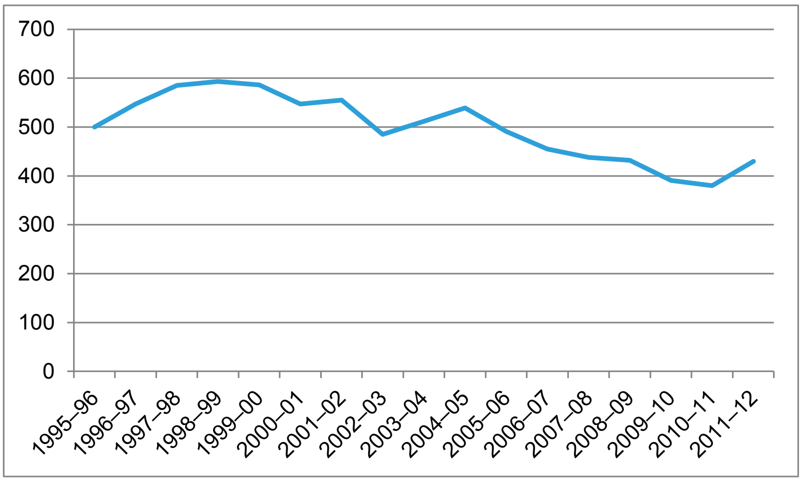
The Australian Securities and Investments Commission (ASIC) recently reported increasing levels of fraudulent activity in the Australian economy in the period July to December 2014[1]. During that period, ASIC 'achieved 348 outcomes' (including convictions, disqualifications and enforceable undertakings).

In the ASIC media release, Commissioner Greg Tanzer's view was:

> ASIC investigates serious white collar crime. We have recently completed several significant enforcement actions after detecting serious fraud by company directors and officers, committed against the companies they serve and the investing public. These results demonstrate that for those who steal and deceive the consequences are great. Current and future areas of focus for ASIC include loan fraud, financial market benchmark rates, illegal phoenix activity and retail margin foreign exchange trading. We expect to achieve noteworthy outcomes as a result of this work.

The Australian Institute of Criminology has maintained statistics on reported fraud incidents since the early 1950s. The following is a comparative yearly estimate of the number of fraud incidents reported to the police across Australia during the period 1995–96 to 2011–12 per 100,000 population:

Figure 1



Source: http://aic.gov.au/publications/current%20series/facts/1-20/2013/2_profiles.html.

In addition, the following is a summary of other recent estimates of fraud:

- In April 2012, the Australian Bureau of Statistics estimated the level of 'personal fraud' (defined as credit card fraud, identity fraud and 'scams') in the financial year 2010–11 at $1.4 billion. It

1 http://asic.gov.au/about-asic/media-centre/find-a-media-release/2015-releases/15-009mr-asic-enforcement-report-july-to-december-2014/

estimated that 1.2 million Australians aged 15 years and over were a victim of at least one incident of personal fraud in the 12 months prior to interview[2];

- The Australian Crime Commission 'conservatively' estimates the extent of serious and organised crime in Australia to be $15 billion annually[3]; and
- In 2009–10, there were 702,941 cases of 'external' fraud against the Commonwealth (such as welfare fraud, tax fraud) involving a loss of more than $495 million[4].

KEY POINT

These figures are only estimates. The true level of fraud in the Australian economy is not known. Consider the impact in financial and non-financial terms, in particular on SMEs. Large corporations and government agencies can recover – many SMEs cannot recover and a large number of them have failed due to simple frauds in recent years.

1.4 A BRIEF OVERVIEW OF THE BROAD CATEGORIES OF FRAUD AND CORRUPTION

Whether you are an auditor, an accountant in private practice, commerce or industry, or a forensic accountant, you will occasionally need to deal with fraud within an organisation with which you have a connection. You will need to be alert to the types of fraud and the indicators of potential fraud and know how to respond when they arise.

A useful classification system for all fraud types was developed by Joseph T. Wells.[5] Wells classification is divided into the three major elements:

Corruption	• Conflicts of interest • Bribery • Illegal gratuities • Economic extortion
Asset misappropriation	• Cash • Inventory and all other assets
Fraudulent statements	• Financial • Non-financial

Many surveys within Australia as well as in the United States and elsewhere around the globe show that the majority of perpetrators of fraud against business are trusted employees who have no prior criminal history. People internal to an organisation have a significant advantage over external parties when it comes to perpetrating fraud – they have the ability to override or circumvent internal controls while external parties have greater difficulty in doing this. Given the proportion of fraud that is committed by people internal to the victim organisation, it is worth considering the sociological/criminological factors in fraud.

The fraud triangle model was developed by Dr Donald Cressey in the United States in the 1950s, based on interviewing 150 people who were prepared to admit their involvement in 'embezzling' funds from their employer.

Dr Cressey suggested three factors that must be in place, all at the same time, in order for an ordinary person to commit workplace fraud:

- Perceived pressure.
- Rationalisation.
- Perceived opportunity.

2 http://www.abs.gov.au/ausstats/abs@.nsf/mf/4528

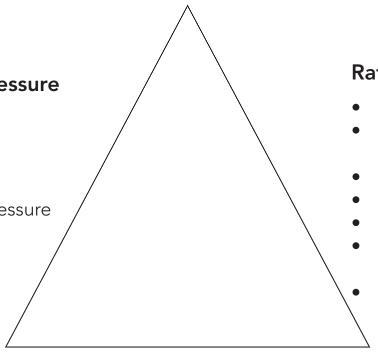
3 https://www.crimecommission.gov.au/sites/default/files/FINANCIAL%20CRIMES%20JULY%202013.pdf

4 http://aic.gov.au/publications/current%20series/facts/1-20/2012.html

5 *Corporate Fraud Handbook – Prevention and Detection*, 4th Edition, John Wiley and Sons, 2013.

These three factors and some examples of how they manifest themselves are shown in the following diagram:

Figure 2



Based on '*Other People's Money*', by Donald Ray Cressey, Free Press, 1953.

For example, a person employed in a middle-management role in a highly profitable business might commit fraud when the three elements of the fraud triangle come into play:

- Perceived pressure: a need to achieve a lifestyle that may have been lost or, in their mind, otherwise denied to them by reason of the relatively modest income.
- Perceived opportunity: the person has control over all funds maintained by the entity and is the key administrator of the business which has limited financial controls.
- Rationalisation: the amount of funds fraudulently taken is not material relative to the total cash funds earned by the proprietors.

Dr Cressey reasoned that fraud could be prevented by removing one of more of the elements.

1.5 WORKPLACE FRAUD

It is clear that there have been hundreds of thousands of workplace fraud incidents in Australia in the last twenty years. Fraud in the workplace can involve any dishonest activity from theft of stationery to the fraudulent misappropriation of millions of dollars in a complex lending fraud within a major bank. The increased reliance on computerisation, the shift of focus away from internal controls, a more mobile and educated workforce, and the involvement of organised crime have all combined to generate opportunities for fraud and corruption in the workplace in this country.