

Fraud Detection and Forensic Accounting

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Abstract: *Fraud involves one or more persons who intentionally act secretly to deprive another of something of value, for their own benefit. Fraud is as old as humanity itself and can take an unlimited variety of different forms. It is both a civil wrong i.e., a fraud victim may sue the fraud perpetrator to avoid the fraud and/or recover monetary compensation and a criminal wrong i.e., a fraud perpetrator may be prosecuted and imprisoned by governmental authorities. The purpose of fraud may be monetary gain or other benefits. However, in recent years, the development of new technologies has also provided further ways in which criminals may commit fraud and the ways to curb fraudulism.*

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1. Introduction

A quick search for the meaning of fraud in the dictionary states that fraud is “deceit, impersonation with intent to deceive/ criminal deception done with the intention of gaining an advantage.”

Reasons to commit fraud:

It can be explained based on three important factors pressure, opportunity and justification which forms “fraud triangle.” Components of the fraud triangle are similar to the fuel, spark, and oxygen which together cause fire. When the three come together, inevitably fire breaks out.

a) Pressure Factors

- Pressures with financial content
- Pressures stemming from bad habits
- Pressures related with job

i) Pressures with financial content:

These pressures could be classified as below

- Itching palm and greediness
- Desire to live well
- High amounts of personal debts
- High amounts of health expenditures
- Unexpected financial needs

Studies show that on average 30% of employees conduct fraudulent activity in the first 3 years, and the remaining 70% attend to forgery processes between the 4th and 35th years of their professional life.

ii) Pressures stemming from bad habits:

Pressures arising from bad habits have attributes related with pressures with financial content. Being a gambler, drug or alcohol addict, and keen on nightlife are among the several reasons causing fraud. This kind of habit is accepted as the worst kind of factors motivating fraud.

iii) Pressures related with job:

Pressures related with the job could be explained as being dissatisfied with the job, the idea of an unfair attitude, not getting promoted when expected, having worked with lower wage, or not being admired by supervisors.

b) Opportunity

Opportunity factors are the third component of the fraud triangle. They directly involve top management and owners of the business in particular. Providing the opportunity to commit fraud is one of the most important factors arising from frauds. Since the business could greatly influence opportunity factor, this point should receive particular attention for fraud prevention.

c) Efforts to Justify Fraud

Some efforts of the fraudsters to justify themselves and the excuse they made up are given below:

- a) I had borrowed the money, I would pay back
- b) This is in return for my efforts for the business
- c) Nobody has suffered as a result of this
- d) I have taken the money for a good purpose
- e) I did not know that this was a crime
- f) Business had deserved this

Characteristic features of the fraudsters:

According to a survey conducted by Association of Certified Fraud Examiners (ACFE) with 2,000 fraudsters here are the few characteristic features of people who commit or are likely to commit fraud,

- a) **Gender:** According to this survey, three out of four of the people who commit fraud are male.
- b) **Marital status:** It is shown that the number of married employees who attempt to commit fraud is higher than unmarried employees. In addition, many of them have children and a happy marriage.
- c) **Education status:** Generally as the level of education increases, the number and amount of the fraud also increase. The amount of the fraud is much higher, especially with employees who had received good education.

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- d) **IQ level:** Employees with higher IQ levels or those claiming to be so have a higher level of desire to commit fraud. The underlying reason of this situation is that this kind of people challenges the internal control structures and security systems where they work in, and satisfies themselves by breaking through them.
- e) **Age level:** Employees of any age could attempt to commit fraud, but the number and amount of the fraud are higher with older people. The number of fraud older people commit is 28 times higher than those young people commit.
- f) **Working conditions:** Generally employees who come earliest and leave latest commit fraudulent activities more. Especially employees who present their unfinished jobs as an excuse and want to work alone until late hours of the night have higher probability of committing fraud.
- g) **Position at the business:** Any person working in the business has a probability to commit fraud. However, studies indicate that with respect to the amount of fraud, employees at managerial positions are by far ahead of other employees. When employees have a trustworthy position, they are monitored less; this is considered as the underlying reason of the preceding fact
- h) **Relations outside of business:** Another indicator is the level of relations employees have with third parties of the business. When an employee becomes very intimate with people buying/selling goods and services from the business, conditions become congenial for fraud to be perpetrated.

2. Types of Fraud

There are two types of fraud committed

- a) Personal use of resources
- b) Drawing up financial statements falsely

a) Personal use of resources

- Embezzlement of the money during its collection but before it is recorded in accounts
- Stealing the cheques of business
- Tampering the bank records and taking monetary advantage
- Gaining advantage through forgery of documents
- Making payments which should not be made or previously made
- Creating fictitious debts and having payments done in favor of oneself
- Giving discount improperly or without authority
- Creating ghost suppliers and having payments made in their favor
- Inventory and scrap theft
- Office supplies and fixed asset theft
- Creating fictitious expenses and obtaining disbursements
- Padding expense items
- Benefiting from placing redundant order
- Creating ghost employees and embezzling their wages/salaries
- Accepting bribes from the customers and suppliers of the business with various reasons
- Using credit cards of the business for personal objectives
- Benefiting from overstated personal expenditures

- Manipulating the overtime periods and obtaining extra payment
- Benefiting from padded travel expenses
- Selling business assets under the market value

b) Objectives of financial statements fraud:

- Increasing the market value of the business
- Making financial statements consistent with budgets
- Obtaining unfair earnings by presenting falsely the value of the business

3. Fraud Detection

Once committed, those involved in the fraudulent acts would normally find it difficult to end the habit.

There are two main ways to detect frauds:

- (a) Detection by chance
- (b) Conducting a proactive research and encouraging initial identification of symptom

In recent years, organizations perform a series of efforts to detect fraud. The most frequent one is establishing hotlines through which employees make anonymous calls to draw attention to the fact that the crime is being committed. However, it must be noted that there might also be false reports made to these hotlines by disgruntled employees.

Apart from the hotline, organizations also take some proactive precautions, technological developments could be used by these organizations to analyze their databases in order to detect red flags. For instance, banks regularly utilize some software to detect fraudulent overdraft balances. Insurance companies also use relevant software in order to identify fraudulent claims by customers immediately after taking out insurance policies.

1) Dealing with fraud: current model



There are four stages in the model shown

The first stage—fraud incident—raises consciousness, while training and other prevention criteria are out of question. In such an environment, fraudulent event occurs. Then the company moves to crisis mode because it wants to identify the fraudster and is too eager to prevent the event from becoming known publicly, save losses, and reduce the impact of fraud on the organization.

The second stage is the investigation stage. All security procedures and internal control are included in this stage.

Much of the investigation is conducted by interviewing and document examination. The investigation might not end up with a decision but could take long time and be costly at the end of the day.

Before the third stage begins, investigation is completed and the company decides how to take action against the fraudster. There are four possible decision actions: do nothing, fire the fraudster, transfer the fraudster to another section, or fire the fraudster and start legal proceeding.

In fourth stage, the file is closed, the employee is changed, and new controls are applied or not applied, and the problem is resolved.

2) Fraud savvy model:

Fraud savvy model which is a better approach in fighting against fraud

There are six elements in fraud savvy model. The most important element is the establishment of moral rules .

Two points are important in establishing these rules:

1. The developed rules must be embraceable by everyone working in the company
2. Creating a proper behavior model

The second element in the model is training of employees on a series of consequences of fraud and how to act when fraud is suspected. As mentioned before, what will provide benefit is not detecting or investigating but preventing the incidence of fraud.

The third element in fighting against fraud includes risk assessment and a good internal control system. The important point in internal control systems is identifying where each fraud is stemming from, thus preventing possible frauds in the future from its very source.

The fourth element is the use of reporting and monitoring systems. The reporting of fraud should be facilitated. There is no doubt that murder and bank robbery are crime. However, fraud is such a crime which could continue for several years. Because hotlines and other reporting systems are not used very frequently, employees could abstain from reporting suspected frauds. Monitoring includes watching the performance of internal auditors, external auditors and managers, and audits and investigations. Reporting also includes conveying the fraud-related information to the people concerned. It involves communicating the fraudulent activity to auditors, security personnel, managers, employees, and those concerned.

The fifth element is the application of proactive detection methods. No matter how good the prevention efforts are, fraud could still be committed. Since the loss that fraud causes increases as time period gets longer, initial detection is important.

Today computer software is used for initial detection of fraud.

The last element in fraud savvy model is investigation and prosecution. In investigation procedure, the following issues must be determined

- 1) Who will conduct the investigation?
- 2) How will the event be communicated to management?
- 3) Whether or not the law enforcing authorities should be brought in.
- 4) Who will determine the scope of investigation?
- 5) Who will determine the methods of investigation?
- 6) Who will trace secret information in suspected fraud?
- 7) Who will interview, examine documents, and undertake other stages of investigation?
- 8) Who will determine the company's reaction against fraud?

3) Forensic Accounting

Maurice E. Peloubet is credited with developing the term forensic accounting in his

1946 essay "Forensic Accounting: Its Place in Today's Economy." By the late 1940s, forensic accounting had proven its worth during World War II; however, formalized procedures were not put in place until the 1980s when major academic studies in the field were published. Forensic accounting is the specialty area of the accountancy profession which describes engagements that result from actual or anticipated disputes or litigation.

"Forensic" means "suitable for use in a court of law," and it is to that standard and potential outcome that forensic accountants generally have to work. Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. This includes tracing money laundering and identity theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorce cases.

Forensic accounting has been pivotal in the corporate agenda after the financial reporting problems. In order to avoid fraud and theft, and to restore the badly needed public confidence, several companies took the step to improve the infrastructure of their internal control and accounting systems drastically. It was this development which increased the importance of accountants who have chosen to specialize in forensic accounting and who are consequently referred as "forensic accountants."

Forensic accounting relies on the fraud triangle to identify weak points in the business systems and find possible suspects in cases of fraud. It consists of three core concepts which together create a situation ripe for fraud: incentive, opportunity, and rationalization. People must have the incentive and opportunity to commit financial fraud, as well as the ability to justify it. Recent analysis has suggested adding a fourth concept to make a diamond—capability. Just because someone has the opportunity or incentive to steal does not necessarily mean that they have the capability to do so.

Forensic accounting and fraud examination are different but related. Forensic accounting work is done by accountants in

anticipation of litigation and can include fraud, valuation, bankruptcy, and a host of other professional services. Fraud examinations can be conducted by either accountants or non-accountants and refer only to antifraud matters.

Fraud management involves a whole gamut of activities: early warnings and alarms; telltale symptoms and patterns of various types of fraud; profiles of users and activities; fraud detection, prevention, and avoidance; minimizing false alarms and avoiding customer dissatisfaction; estimating losses; risk analysis; surveillance and monitoring; security (of computers, data, networks, and physical facilities); data and records management; collection of evidence from data and other sources; report summaries; data visualization; links to management information systems and operation systems (such as billing and accounting); and control actions (such as prosecution, employee education and ethics programs, hotlines, and corporation with partners and law enforcement agencies).

In recent years, corruption has attracted the attention on fraud in many organizations. The traditional auditor was following a reactive approach during the audit process. Now we see that proactive approaches have begun to replace the reactive solutions. Once the loss has occurred, neither detection nor investigation could compensate the loss. Due to this fact, the most important thing companies have to do with regard to fraud is to prevent the crime from being committed.

To prevent the crime, two concepts move to the top of the corporate agenda: deterrence and motivation. Rules, regulations, and legislation play deterrence role, while motivation is provided with education and training.

Forensic accounting, which has been growing rapidly as a profession in the world and has been accepted as a profession in countries such as Canada, Australia, the USA, and the UK, is beginning to gain the importance that it deserves. Let us welcome this new profession to India even for its betterment.

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