Forensic Accounting Applications in Financial Fraud

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1.0 Introduction

This report includes financial frauds and major problems that are related to fraudulent financial statements also, it includes the ways it is allowed to happen. Forensic accounting ensures that any fraud and manipulation have occurred in financial statements. Mostly, financial statement frauds are perpetrated by the top management and the concerned officials. They cannot be anybody in the organization for the forensic accounting application. Financial statements fraudulent are perpetrated by the top management and the concerned officials. Moreover, this report will include the ways and measures using which fraud against financial statements can be deducted as well as investigated. Furthermore, the issues that can be arises in the investigation include the disadvantage of being biased against the company being the subject of the inquiry. Hence, this fraudulence can be prevented and controlled by Having strong internal control and by Inviting an independent auditor. All of these controls are interconnected parts and are abbreviated as CRIME: cooks, recipes, incentives, monitoring, and final outcomes, to name a few the acronyms (CRIME).

1.1 Financial Statement Fraud Is A Major Problem

The Core Meaning Of Forensic Accounting

Forensic accounting is the study and analysis of financial data in order to determine if fraud or financial manipulation occurred. Insurance claims, divorces, bankruptcy, fraud, skimming, embezzlement, and other forms of financial theft are all common reasons for hiring forensic accountants (Omidi et al., 2019).

How is financial statement fraud defined?

- Deliberate misstatements or misrepresentations concerning the financial condition or performance of an organisation.
- It is manufactured by manipulating, falsifying, or altering accounting records or by omitting key information from financial statements.
- Errors are unintentional misrepresentations of financial statements that are distinct from fraud.

Financial Statement Fraud Executive

Auditors, board members, and regulatory agencies all do have a part in fraud; in reality, the latter is governance control mechanisms tasked with the primary responsibility of preventing financial crimes inside the organisation.

Senior executives, including chief executives, chief operating officers, chief financial officers, and owners, are more likely to perpetrate financial statement fraud. This is the group that will profit most from a healthy bottom line. In general, a manager or entrepreneur will conduct fraud if the organisational environment is favourable and the management has a profile that signals he or she is prone to commit fraud (Anichebe, 2019).

Fraud executives of Andersen scandal

The top management team at Waste Management, which included the company's CFO and CFO-elect, was under Cooks' supervision. Ultimately, internal whistleblower Sherron Watkins caught the culprits (Jan 2018).

Major Issues With Financial Statement Fraud

A company's stock price may be significantly affected by its financial statements. Investing decisions are often preceded by a review of personal financial history. The stock price may rise or fall if the financial statement data is better or worse than predicted. Financial ratios derived from financial statement data are often the foundation on which investors build their expectations. As a consequence, the fraudulent financial statements of a corporation may have a significant impact on investors.

Fake income or financial records are grounds for fraud charges against anybody, no matter their size. Debtor's dishonesty in bankruptcy may be based on failing to disclose income from a freelance job.

Companies having incorrect payroll records (such as cash workers who are not considered employees) or missing important financial documents may also raise red flags (Nindito, 2018).

Disparities between a borrower's financial statements and their most recent tax filings suggest that the borrower is trying to hide assets or inflate obligations on purpose. Difficult firms may be more proactive in their tax filings. Financial ruin may be shown in tax evasion, delaying the bankruptcy procedure indefinitely.

Two common money-manipulation strategies include hiding or missing assets and misrepresenting family income. If allowed unchecked, this might lead to one spouse receiving a disproportionate share of the family's assets. Ex-spouses who say their ex is piling up debts or emptying bank accounts might convince relatives and friends to help hide marital assets. In the end, fraud is all about deceiving others (Rechtman et al., 2019). Divorce financial investigations may uncover a wide range of fraud, including money laundering and tax evasion. Even though there have been cases of forgeries and forged documents, tax, loan and insurance fraud, the majority concern asset theft after a divorce.

Financial Statement Fraud Became A Problem For Andersen

The SEC filed a civil fraud lawsuit against three Andersen partners who were engaged in the audit, and all three agreed to settle without admitting or denying the allegations. As a result of Enron's financial collapse, Andersen LLP and its partner David B. Duncan were two of the most influential people. Andersen was regarded as one of the top 5 accounting companies in the United States at the time, with a reputation for high ethical standards and sound risk management procedures (Uwuigbe et al.,2019).

Methods: Fraudulent Financial Statements Allowed To Happen

There are two ways to tamper with financial statements. First, it is conceivable to artificially deflate current period expenditures or to artificially inflate revenue and profits, or, in order to overestimate fiscal year revenues on the income statement. In order to match pre-existing expectations, the organisation inflates its financial situation using this method.

The second method is to exaggerate current period revenue or deflate current period costs to minimise current period earnings on the income statement. When the bad press is dealt with today, the company seems stronger in the future. Some argue that bad outcomes may be blamed on present macroeconomic difficulties or that positive financial data can be held back until an unpleasant moment in the future. Alternatively, it is possible to postpone the release of vital financial data to a far future date (Young, 2020).

There are several ways in which a firm may falsify data. Incorporated management, according to Howard Schilit's book, manipulates the financial records of a corporation by using seven major strategies that are:

1. **Records of Revenue That Are Either Too Soon or Are Inacceptable**

   In this method, it is Prior to the completion of all services; it is important to keep financial records. Moreover, under this method, Before the product is delivered, revenue is recognised. This method entails keeping track of non-essential items' revenue.

2. **False Revenue Collection**

This method embraces keeping track of monies obtained via erroneous transactions. In order to measure revenue, investment profits are taken into account. Moreover, under this method, Loan repayment includes a statement of income.

3. **Taking Advantage of One-Time Gains to Boost Your Income**

This method ensures Increasing profitability through selling assets and recognising revenue. Moreover, Capital gains and investment income might be reclassified as revenue in order to increase profits (Goklas and Manurung, 2022).

4. **Shifting current expenses into an earlier or later time frame**

Under this method, Expenses are amortised at a pace that is much too slow. Moreover, this method pressurises toward Changing the rules of accounting to encourage fraud. For the sake of saving money, relocating expenses from the income statement to the balance sheet. This method shelters the writing off assets that do not depreciate is referred to as "non-depreciation."

5. **Shifting Current Revenue to a Later Period**

This method emphasises Establishing a rainy-day reserve for future performance. Moreover, this method ensures that Income taxes are withheld from wages (Omidi et al., 2019).

6. Shifting Future Expenses to the Current Period as a Special Charge

This method assures the Accelerating expenses into the current period. Moreover, manipulating accounting standards, particularly via depreciation, amortisation, and depletion allowances is a common practice.

False entries in journals and other documents, as well as adjustments to financial statement data, are often used ways to conceal financial statement fraud.

Following revenue and receivables, inventory and cost of goods sold are the most typical financial statement frauds (Petra and Spieler, 2020).

Fraudulent Financial Statements Allowed To Happen In The Anderson Scandal

A five-year period of increased income but hidden costs followed. Finally, a wide range of fraud incentive programs benefits both the customer and the auditors in equal measure. When it came time to meet or exceed investor expectations, managers were feeling the heat. Every CFO and CCO in the company's history had previously worked as an auditor at Andersen. Andersen's auditors had clear conflicts of interest with Waste Management's top management (Omidi et al., 2019).

1.2 Methods To Deduct The Fraudulent Financial Statements

While spotting red flags in financial statements might be difficult, doing a vertical and horizontal financial statement analysis makes the process much simpler. In vertical analysis, the percentage change in each line item on the income statement over the previous year is compared to the total sales to discover any irregularities.

A similar approach may be used to monitor large deviations from usual activities on the balance sheet, with total assets serving as a point of comparison. An account is used as a reference point in the horizontal analysis, but the financial data is reported as a percentage of the previous year's performance instead.

It is also possible to use comparative ratio analysis to detect financial irregularities. Calculate and check for inconsistencies concerning the day's receivables sales, leverage multiples, and other important indicators using ratio analysis (Rengganis et al., 2019).

Among the eight factors included in the Beneish Model are depreciation, asset quality, gross margin, and leverage. M-score is calculated after combining the variables into the model.

Methods To Investigate The Fraudulent Financial Statements

In some cases, an internal investigation guided by outside counsel and inside counsel, ideally a certified public accountant or a lawyer with substantial accounting experience, and conducted by a forensic accounting team may be able to determine whether the financial statement difference was the result of a mistake or fraudulent activity. In the forensic accounting team, the principal attorney is known as the "counsel". Outside counsel will be able to provide legal advice to the board of directors, audit committee, or in-house counsel in their position as their representative as a result of the material gathered by the forensic accounting firm. Consequently, the investigation is conducted in strict line with attorney work product confidentiality, and the board may reveal the results of the investigation to other parties, such as law enforcement or prosecutors, at its discretion (Puspitha and Yasa, 2018).

Furthermore, the results of the inquiry may entail the restatement of previously audited financial records, depending on the circumstances. During the audit of the financial statements, the financial statement auditor will need some degree of testing of the forensic accounting team's findings to ensure that the auditor feels management's restatement of the financial accounts is reasonable. Without jeopardising the confidentially of the investigation's work output, outside counsel must be able to make disclosures to the financial statement auditor from the internal investigation that is required for the auditor to perform their duties.

Investigation of Andersen Scandal

In response to the SEC's inquiry, Dynegy, a Houston-based competitor, offered to purchase the firm at a discount. Under Chapter 11 of the U.S. Bankruptcy Code, Enron declared bankruptcy on December 2, 2001 (Abdullahi and Mansor, 2018).

Issues Arise In The Internal Investigation

Throughout the course of an internal investigation, ethical problems may and do arise. The investigation's credibility may be improved by anticipating ethical difficulties and devising a strategy for addressing them. Carefully addressing ethical issues gives the inquiry process authenticity, speeds it up, and builds regulator trust (Sadgali, Sael, and Benabbou, 2019).

Internal investigations carried out by in-house investigators have the disadvantage of being biased against the company being the subject of the inquiry. In situations when an inside team investigates and resolves workplace issues on behalf of a company, the likelihood of bias rises. Prejudice might be used as a factor in an investigation, but it would be a mistake for a professional to do so. If the matter goes to trial, a skilled plaintiff's attorney may claim that the investigation was conducted incorrectly or that the results were unjust because of bias.

Investigations conducted by in-house counsel may sometimes encounter difficulties since the concept of "privilege" is not always clear. Internal inquiries are often carried out behind closed doors. This means that in-house lawyers must demonstrate that their communications concerning the investigation are focused on providing legal advice rather than commercial advice. An important distinction that is often misunderstood may be found here. Due to the difficulties in monitoring former employees, the issue may become even more convoluted (Young, 2020).

Hiring consultants from outside your company might provide a variety of advantages. Services that specialise in investigating corporate misconduct may have new suggestions based on their years of experience dealing with similar cases. Expert third-party organisations often connect with extra specialists (such as data security and research experts) that may not be immediately available to a company's internal employees, such as quantitative analysts and e-discovery experts.

1.3 Prevention of Fraudulent Financial Statements By Applying Some Policies

a. **Don't tie a significant amount of Management's Compensation to Bonuses Based on Short-Term Goals.**

Maintain a balance between long-term incentives and short-term rewards for managers. Thus, dishonesty and lying become more prevalent.

b. **Invite an independent auditor.**

Knowing that financial accounts will be inspected on a regular basis makes workers less inclined to engage in fraudulent activity.

c. **Set Up a Hotline/Reporting System**

In accordance with the ACFE study, the most popular method of identifying fraud is via reporting systems (39.1 per cent). Organisations that made use of hotlines had a much higher proportion of fraud detection than organisations that did not.

d. **Create a Company Culture Devoted to Honesty and Integrity**

When it comes to job policies, integrity and honesty should be admired. The ability of employers and managers to speak openly about equal employment chances and other problems should be a fundamental right in the workplace. Make everyone's expectations and procedures very apparent, and hold them all to the same high level, regardless of their position must a considerable policy to set in any organisation to prevent any fraud cases (Uwuigbe et al.,2019).

Applying the control and Evaluation of control

After taking a thorough look at these high-profile alleged financial statement frauds, it becomes clear that there are five basic features of how individuals interact with one another to control fraudulent financial statements. All of these controls are interconnected parts and are abbreviated as CRIME: cooks, recipes, incentives, monitoring, and final outcomes, to name a few the acronyms (CRIME).

Many contributions are made by the fundamental concept of "five interaction components" that underpins the name "CRIME." After describing financial statement fraud by emphasising five interwoven components that characterise the origins and effects of financial statement fraud.

Secondly, it emphasises the critical role that corporate governance actors, such as internal and external auditors, the board of directors, management, the audit committee, and regulatory organisations, play in preventing and detecting financial statement fraud, as well as the importance of training and education, for example, SEC, the Securities and Exchange Commission, and the American Institute of Certified Public Accountants, AICPA (Rechtman et al., 2019).

Cooks

"COOKS" is an acronym for "C" as a crime which is an abbreviation for "CORRUPTION." Many of these instances included the CEO or CFO directly or indirectly involved in the falsification of financial records (more than 80 per cent). Controllers, COOs, board members, other senior vice presidents, and both internal and external auditors are among the most prevalent offenders of accounting fraud, according to the BDO Global Fraud Database. Financial statement frauds are performed with the knowledge and cooperation of top management teams, including the secretary, chief financial officer, the chief executive officer, treasurer, president, and controller, to mention a few of those who have a stake in the outcome of the fraud (Rengganis et al., 2019).

Recipes

In financial statement fraud, overstating revenue and assets while understating obligations and expenses are two of the most prevalent methods in which the deception appears on the financial statement. The presence of intra-quarterly financial account errors is often a forerunner to the occurrence of year-end financial statement irregularities. It is outcomes management (the manipulation of results in order to fit earnings objectives, analyst estimates, and/or an earnings trend) that is the most often used technique of financial statement fraud (Anichebe, 2019).

Incentives

Financial statement fraud is fueled by a range of variables, including financial incentives, that push organisation and their workers to commit fraud on financial statements.

Monitoring and evaluating

The motivations of those who commit financial statement fraud are always purely economic in nature, regardless of whether they are psychotic, narcissistic, or ideological in nature. Publicly traded companies often misrepresent their financial accounts in order to fulfil the expectations of Wall Street as well as their own internal growth ambitions (Jan 2018).

End results

It is clear that the repercussions of financial statement fraud may be catastrophic. It is likely that the company may file for Chapter 11 bankruptcy, have its ownership changed, get delisted from the national stock market, or have its stock value plummet. Many senior executives who "cook the books" are forced to retire or are fired by their companies, and they are barred from serving as officers or directors of another publicly-traded company by the Securities and Exchange Commission (SEC), as well as being fined or imprisoned. (Rechtman et al., 2019).

Fraud control team of Anderson

The chief financial officer and the chief accounting officer cooked the senior management team of Waste Management. In the recipe, for five years, the system exaggerated profits while hiding spending. Moreover, financial statement fraud incentives benefitted the consumer and the auditors. A lot of pressure was put on the management team to meet their profit projections and please Wall Street (Petra and Spieler, 2020).

More than ever, in today's fast-moving capital market, management is under pressure to outperform analysts' predictions. Waste Management was pressured for several years to divulge found financial statement irregularities.

1.4 Conclusion

It can be concluded that Insurance claims, divorces, bankruptcy, fraud, skimming, embezzlement, and other forms of financial theft are all common reasons for hiring forensic accountants. Senior executives, including chief executives, chief operating officers, chief financial officers, and owners, are more likely to perpetrate financial statement fraud. Moreover, Methods of Fraudulent financial statements allowed to happen in organization with consent of top executives. This happens in way that before the product is delivered, revenue is recognized. Moreover, method entails keeping track of non-essential items' revenue. Prevention of fraudulent financial statements can be possible by applying some policies. When it comes to job policies, integrity and honesty should be admired. In case of Andersen scandal, the chief financial officer and the chief accounting officer cooked the senior management team of Waste Management.

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