

THE RELEVANCE OF FORENSIC ACCOUNTING IN DETECTING FINANCIAL FRAUDS

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ABSTRACT

Berbagai skandal akuntansi telah mendorong munculnya perdebatan yang menanyakan kemampuan akuntansi dalam menyediakan informasi keuangan yang bermanfaat. Masyarakat luas juga mulai mempermasalahkan peranan auditor, regulasi dan mekanisme tata kelola perusahaan dalam mendeteksi kemungkinan terjadinya kecurangan keuangan. Penulis berpendapat bahwa kurang independennya auditor, lemahnya penegakan hukum, dan ketidakmampuan mekanisme tata kelola perusahaan dalam memonitor perilaku manajer merupakan faktor utama yang mendorong terjadinya skandal akuntansi di berbagai negara. Untuk mencegah skandal sejenis, masyarakat luas sebenarnya memerlukan forensic accounting. Atas dasar hal tersebut, forensic accounting sudah seharusnya dipertimbangkan sebagai bagian dalam mendesain kurikulum akuntansi dan menjadi area penelitian di Indonesia.

Kata kunci: forensic accounting/auditing, litigasi, penelitian kualitatif, skandal akuntansi.

Accounting has been perceived as a medium to provide useful information for economic decision making. However, a number of accounting and business scandals occurred around the world have attracted criticism on accounting. The public has witnessed a number of well-known examples of accounting scandals and bankruptcy involving large and prestigious companies in developed countries. The media has reported scandals and bankruptcies in companies such as Sunbeam, Kmart, Enron, Global Crossing (USA), BCCI, Maxwell, Polly Peck (UK) and HIH Insurance (Australia). Besides scandals in developed countries, which have sophisticated capital markets and regulations, similar cases can be also seen in developing countries with emerging capital markets. As reported by Johnson, Boone, Breach, and Friedman (2000), Asian countries have experienced similar cases, such as PT *Bank Bali*, and *Sinar Mas* Group (Indonesia), Bangkok Bank of Commerce (Thailand), United Engineers Bhd (Malaysia), Samsung Electronics and Hyundai (Korea).

These cases imply that the corporations have failed to supply accurate information to their investors, and to provide appropriate disclosures of any transactions that would impact their financial position and operating results. The recent accounting scandals have induced a crisis of confidence in financial reporting practice and effectiveness of corporate governance mechanisms (Bartley, 2002; Browning 2002; O'Connell, Webb, & Schwarzbach, 2005). Accordingly, a number of efforts have been conducted to prevent the possibility of similar scandals. In addition, discussion on the relevance of forensic accounting in detecting accounting scandals has emerged in recent year. This paper will discuss accounting and business scandal and the possibility of forensic accounting to detect and prevent fraudulent financial reporting.

QUESTIONING FINANCIAL REPORTING PRACTICE

Although a number of efforts have been made to improve financial reporting, there is a lack of consensus as to what constitutes financial reporting quality (Cohen, Krishnamoorthy, & Wright, 2004). The current claim is that quality financial reporting is based on qualitative characteristics set by the regulatory bodies and the quality is achieved in accordance with generally accepted accounting principles and generally accepted auditing standards. Such characteristics include relevance, timeliness, reliability, verifiability, representational faithfulness, neutrality, comparability and consistency, materiality, feasibility or costs and benefits, and transparency.

Miller and Bahnson (2002) consider the quality of financial reporting from capital market perspectives focusing on voluntary disclosure. They point out that quality financial reporting is a means by which companies report

...as much useful financial information as possible to the capital markets, including the public, the stockholders, and the company's creditors...by voluntarily providing market value-based and other information that the capital markets consider to be useful for assessing the value of the company's securities.

According to this view, financial reporting is concerned not only with the shareholders' interests, but also with the public's interests. Quality financial reporting is focused on the development of an efficient capital market. It is intended to enable market players to measure share prices traded in the capital market.

What Miller and Bahnson (2002) mean is that the only way to produce quality financial reports is by providing more information beyond the minimum requirement set by laws/regulations, and that such information must be focused on market-value information to create capital market efficiency. This concern is concentrated on the future-oriented information, rather than the way of presenting the information. In regard to disclosure and the way of presenting information in financial reports, Bromwich (1992) claims that

...[it] does not matter how information is disclosed. It is information itself, which matters. Thus accounting information is seen as merely one possible source of information which may often repeat items already available from other sources. With this view, disclosure via accounting reports of information not available from other sources would seem likely to improve decision making...It is the information itself which is of concern, not how it is presented. Any new information contained in published accounting reports will be discovered quickly in efficient markets, irrespective of how or where the information is positioned in accounting statements.

This assertion is similar to the arguments by Wolk, Dodd, and Tearney (2004). They believe that the ability of a firm to raise capital will be improved if the firm has a good reputation with respect to financial reporting.

However, it is believed that because of opportunistic behaviours, managers might prefer to pay little attention to the present and future cash flows and use accounting policies that make a company look more attractive. Indeed, Revsine (1997) posited that when publishing financial reports, managers prefer reporting methods that provide latitude in income determination...rather than methods that tightly specify statement numbers under given economic conditions. By providing managers with control over when they can report externally driven events, loose reporting standards can be used by managers to increase compensation, and to hide perquisite consumption, incompetence, or laziness.

Revsine (1997) continues to argue that ...manager's preferences for "loose" financial reporting standards also arise for reasons other than bonuses. These include, for example, enhancing reported performance in an attempt to (1) impress shareholders and (2) protect their jobs by forestalling takeovers.

This phenomena leads us to question whether the current practice shows quality financial reporting and does management show ethical behaviour in presenting financial reports?

ACCOUNTING SCANDALS: WHAT IS THE PROBLEM?

Even though endeavours have been directed to produce quality financial reporting, it is apparent that quality financial reporting is often an illusion or myth. In practice, as can be seen from a number of accounting scandals and bankruptcies, some companies have published low-quality financial reports and provided misleading information. Quality financial reporting is still a dream of accountants. It seems to be a myth. The reality of financial reporting is different from what people currently believe.

It might true that theoretically accounting is intended to provide useful information. Bromwich (1992) argues that accounting reports are seen as the only means of publishing information. In the model of decision-making theory (see for example Demski, 1980; Marschak & Radner, 1972), it is claimed that individual's past knowledge and experience will be inspired by any information gained over their lifetime (Bromwich, 1992). Thus if managers believe that users can be fooled by managing earnings, they will continue to produce low-quality financial reports.

In the case of WorldCom, for example, it can be seen that in 2002 WorldCom filed the largest bankruptcy in accounting history, revealing that management fraudulently misstated earnings. Arthur Andersen, WorldCom's auditor, failed to notice US\$3.85 billion shifting of funds to cover up revenue shortages (Oliver, 2004). The Enron case also showed a similar pattern of earnings management. Enron had "aggressive earnings targets and entered into numerous complex transactions to achieve those targets" (Jennings, 2003).

Furthermore, it is claimed that the involvement of independent auditors can reduce the possibility of frauds in a company. However, their involvement goes beyond auditing functions, which leads to low-quality financial reporting. For example, Arthur Andersen, a well-known accounting firm, let the line between consulting and auditing blur. The collapse of large companies worldwide (HIH insurance, Enron, WorldCom) have sparked lively interest in the amount of consultancy fees that external auditors receive in addition to audit fees. In the Australia environment, HIH insurance paid Andersen A\$1.7 million for audit services and A\$1.6 million for consultancy services for the 1999–2000 financial year (Pha, 2001). As a consequence, it has been argued that the role of external auditors has been subject to the influence of the board of directors of the company (Byrne, 1998; Tinker, 1991).

The Enron collapse showed a similar relationship between Andersen and Enron. In fact, "[w]hile the Enron/Andersen relationship was extreme, its individual components provide indications of how a relationship can become so muddled that auditor independence is sacrificed" (Jennings, 2003). The above evidence shows that auditors were not independence and this can lead to low-quality financial reporting.

In general, it can be claimed that the above accounting scandal occurred because of integrated factors. Such factors include lack of auditor independence, weak law enforcement, dishonest management, weak internal control and in ability of corporate governance mechanism in

monitoring management behaviours. Consequently, there should be alternative tools to detect the possibility of financial frauds. Forensic accounting can be seen as one of such tools.

DO WE NEED FORENSIC AUDITING?

Forensic accounting gets its name from association with a court of record; forensic accounting and auditing are performed to achieve an objective that involves a judicial determination. By definition, forensic accounting includes the use of accounting, auditing, and investigative skills to assist in legal matters. It comprises two major components: litigation services that recognize the role of an accountant as an expert consultant, and investigative services that use a forensic accountant's skills and may require possible courtroom testimony (Coulbert, 2004).

According to the definition developed by the AICPA's Forensic and Litigation Services Committee, forensic accounting may involve the application of special skills in accounting, auditing, finance, quantitative methods, the law, and research (Houck, et al., 2006). It also requires investigative skills to collect, analyze, and evaluate financial evidence, as well as the ability to interpret and communicate findings. Forensic accounting encompasses litigation support, investigation, and dispute resolution and, therefore, is the intersection between accounting, investigation, and the law (Coulbert, 2004; Crumbley & Apostolou, 2005; Rezae, 2002). Hence, forensic accounting/auditing is mainly intended to prevent and detect the existence of fraudulent financial reporting through examination and investigative processes.

The above views shows that forensic accounting can be considered as a methodology for resolving fraud allegations from inception to disposition, including obtaining evidence, interviewing, writing reports, and testifying. The ACFE's manual states that fraud examiners also assist in fraud prevention, deterrence, detection, investigation, and remediation (Rezae, 2002). Like most forensic sciences, fraud and forensic accounting may involve using financial information to piece together or reconstruct past events in instances where that reconstruction is likely to be used in some judicial proceeding (e.g., criminal or civil court, deposition, mediation, arbitration, or settlement negotiation). Fraud and forensic accounting is a broad area that includes occupational fraud, corruption and abuse, financial statement fraud, and civil litigation matters (Crumbley & Apostolou, 2005). While the reconstruction activity tends to look backwards, the impact may have implications for the future, particularly in civil torts and breach of contract claims.

WHAT IS THE ROLE OF ACCOUNTANTS AND WHAT SKILLS SHOULD THEY HAVE?

An understanding of effective fraud and forensic accounting techniques can assist forensic accountants in identifying illegal activity and discovering and preserving evidence (Houck, et al., 2006). Hence, it is important to understand that the role of a forensic accountant is different from that of regular auditor.

It is widely known that an auditor determines compliance with auditing standards and considers the possibility of fraud. Crumbley and Apostolou (2005) claim that a forensic accountant has a single-minded focus on the detection and deterrence of fraud. Robert Roche, as cited by Crumbley and Apostolou (2005), describes a forensic accountant as someone who can look behind the facade--not accept the records at their face value--someone who has a suspicious mind that the documents he or she is looking at may not be what they purport to be and someone who has the expertise to go out and conduct very detailed interviews of individuals to develop the truth, especially if some are presumed to be lying.

Forensic accounting often involves an exhaustive, detailed effort to penetrate concealment tactics. Stephen Seliskar says, "in terms of the sheer labor, the magnitude of effort, time, and expense required to do a single, very focused [forensic] investigation--as contrasted to auditing a set of the financial statements--the difference is incredible." (quoted by Krell, 2002).

The above views imply that the role of forensic accountant is different from that of other accountants. They are different in their further education and training or years of experience. In addition, forensic accountants are closer to being *investigators*, *economists*—who do economic and market estimation and *appraisers*—who are typically trained in finance or valuation theory in business.

As an investigator, a forensic accountant can be seen as those who are specialists in fraud detection, and particularly in documenting exactly the kind of evidence required for successful criminal prosecution; able to work in complex regulatory and litigation environments; and with reasonable accuracy, can reconstruct missing, destroyed, or deceptive accounting records. Meanwhile, as an economist, they are particularly effective at economic loss, damage, and social harm estimates; familiar with the assumptions, algorithms, and calculations in econometric models and opportunity cost scenarios; can measure and quantify such things as loss of goodwill and reputation. Finally, as an appraiser, forensic accountants should be able to reliably express informed opinion on matters of business value, based on generally accepted theory; effective at evaluating the historical and projected degrees of risk and return of any going concern as well as any and all financial transactions involving assets, property, taxes, and equities (Bologna & Lindquist, 1995)

Moreover, Bologna and Lindquist (1995) assert that fraud auditing is an emerging, new discipline, which involves skills not unlike those of a financial crime investigator. Regular auditors focus on errors, omissions, exaggerated assertions, misstatements of fact, and even though they sometimes track "suspicious" things, a regular auditor might never use that word. Fraud auditors, by contrast, focus on exceptions, oddities, irregularities, patterns, and suspicious things. A regular auditor will detect fraud only 10% of the time (Bologna & Lindquist, 1995). Such detection will probably be by accident, most likely because of the random sampling nature of what a regular auditor looks at. Fraud auditors might improve on this detection percentage by going straight to the types of accounts where fraud is most likely to occur.

In addition, the characteristic that differentiates fraud auditors and forensic accountants from regular auditors is the persistence and doggedness to which a suspicion is followed up on. Forensic accountants may be ordered in by a regulatory agency after receiving notice from an employee whistleblower, or press coverage may make it known that the company has a scandalous CEO or history (Bologna & Lindquist, 1995). There are no professional standards for when regular auditors should become whistleblowers, and unfortunately, the involvement of a forensic accountant is almost always reactive. There is a need for more proactive monitoring of the signs of financial crime.

Furthermore, forensic accountants react in response to criminal complaints, statements made in civil litigation, and rumors that come to the attention of authorities. *Suspicion* should perhaps refer to signs of cover up or disguise (Rezae, 2002). Class-action suits by shareholders may stimulate a forensic accounting investigation, but class-action suits only hurt the corporation, and let the offending CEO go free. Regular auditors, as we have seen, also tend to not make good witnesses in court, and they sometimes are more a hindrance than help for law enforcement. There may be a need for the auditing and assurance professions to change their ways before new, emerging fields move in to fill the gap.

In regard to the above arguments, forensic accounting should play an important role as expert witnesses and fraud investigators. Accordingly, forensic accountants should possess a specific skills and training that enable them to play their roles as expert witnesses and fraud investigators.

The area of study known as forensic accounting, as Houck, et al (2006) argue, consists of a rather unique skill set that ordinarily requires additional expertise and training beyond an academic degree in accounting, and beyond being a CPA (Certified Public Accountant), a CFE (Certified Fraud Examiner), or CIRA (Certified Insolvency and Restructuring Advisor). Certifications are good in designating a high degree of professional expertise in rather specialized areas, but further graduate education and continuing education programs in more general fields would be better. More specifically, entry-level fraud and forensic accounting professionals should possess knowledge, skills, and abilities in the following areas (Houck, et al., 2006):

1. Criminology specifically oriented to the nature, dynamics, and scope of fraud and financial crimes; the legal, regulatory, and professional environment; and ethical issues.
2. Fraud prevention, deterrence, detection, investigation, and remediation in the following areas: asset misappropriation, corruption, and false representations; financial statement fraud; and fraud and forensic accounting in a digital environment, including computer-based tools and techniques for detection and investigation, electronic case-management tools, and other issues specific to computerized environments.
3. Forensic and litigation advisory services, including research and analysis, valuation of losses and damages, dispute investigation, and conflict resolution (i.e., arbitration and mediation).

Considering the above views, it seems that forensic accounting plays a significant role in preventing and detecting possibilities of fraudulent financial reporting. It can be seen as an attainable effort to improve quality financial reporting through education and provide other alternative research in accounting.

CONCLUSION

To sum up, the need for achieving quality financial reporting is questionable. Opportunistic behaviours have lead to fraudulent financial reporting practice. Because forensic accounting is not the same as regular audit, it is the time for forensic accounting to prevent and detect such frauds even though detection of fraud has been noticed in some regulation, such as in the Sarbanes-Oxley Act (SOX). In regard to the Indonesian jurisdiction, *Standar Profesional Akuntan Publik (PSA70)* also request auditors to consider the possibility of fraudulent financial reporting.

What do the above arguments imply for accounting education? It is clear that auditors should have investigative skills in performing their jobs. Consequently, accounting curriculum should consider subjects discussing forensic accounting/auditing. Such curriculum should also be directed to provide students with understanding of organisational culture, business and professional ethics, corporate governance issues, and investigative skills.

In regard to accounting research, it is well known that several research approaches or methods are currently available to help researchers analyse phenomena-both using qualitative and quantitative research. Forensic accounting and other accounting areas can be seen from the understanding that reality exists as a social product and as a result of human interaction, symbolic discourse and creativity (Burrell & Morgan, 1979; Denzin 1983; Hopper & Powell, 1985; Morgan, 1980; 1988; Tomkin & Groves, 1983). Therefore, to understand why and how a company is committed to fraudulent financial reporting practice and how forensic accounting can detect and prevent frauds, an appropriate research approach is needed.

The interpretative approach is seen as appropriate because it enables the researcher to understand how financial reporting is practised in an organisation by considering values, beliefs, norms and structures accepted by organisational members, and by considering external factors, which are viewed as influencing financial reporting practice. In addition, such an approach is used because the aspect of human values, culture and relationships are unable to be described fully using quantitative research methods. In common with Boland and Pondy (1983), the research objective "is not to study accounting *per se*, but to study individuals acting in organisations as they make and interpret accounts". Financial reporting practice can only be developed by reference to a particular setting in which it is embedded (Hopwood, 1983; Miller, 1994). Thus, qualitative research could be seen useful to explore and describe fraudulent financial reporting practice and the role of forensic accounting on it.

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