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Financial Statement Fraud: The Need for a Paradigm Shift to Forensic Accounting

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Abstract**—**The unrelenting series of embarrassing audit failures should stimulate a paradigm shift in accounting. And in this age of information revolution, there is need for a constant improvement on the products or services one offers to the market in order to be relevant. This study explores the perceptions of external auditors, forensic accountants and accounting academics on whether a paradigm shift to forensic accounting can reduce financial statement frauds. Through Neo-empiricism/inductive analytical approach, findings reveal that a paradigm shift to forensic accounting might be the right step in the right direction in order to increase the chances of fraud prevention and detection in the financial statement. This research has implication on accounting education on the need to incorporate forensic accounting into present day accounting curriculum. Accounting professional bodies, accounting standard setters and accounting firms all have roles to play in incorporating forensic accounting education into accounting curriculum. Particularly, there is need to alter the ISA 240 to make the prevention and detection of frauds the responsibilities of bot those charged with the management and governance of companies and statutory auditors.

Keywords**—**Financial statement fraud, forensic accounting, fraud prevention and detection, auditing, audit expectation gap, corporate governance.

I. Introduction

A. Purpose Statement

THE purpose of this study was to examine the perception of Statutory Auditors, Forensic Accountants and Accounting Academics in the United Kingdom on how a paradigm shift to forensic accounting can help to reduce financial statement fraud. As it stands presently, the current accounting paradigm consist of reporting and procedural auditing, which over the years have not guarantee the prevention and detection of frauds in the financial statement.

B. General Background to the Study

The frequency of financial statement frauds over the last two decades call for greater concern by the accounting profession [16], [20]. Fraud, particularly that which relates to financial statements is in the news almost every week, if not on a daily basis [8]. Just recently, some highly successful companies like Hertz, Tech Data, IEC Electronics, Orthofix, Overstock.com, Tesco, Olympus and Toshiba just to mention a few, filed applications to restate their financial statements while some companies were forced by the Securities and Exchange Commission (SEC) to restate their financial statements [6]. This kind of occurrence is a serious threat to the integrity of financial reporting and corporate governance system [7], [10], [23].

Financial statement fraud is a form of occupational fraud [2], which involves the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements in order to deceive financial statement users [1].

Lately, financial statement frauds have become a global phenomenon which can affect all organizations regardless of their size [1], [7]. It is often the practice of the media to report only those high profile fraud of large multinational corporations [7], this is probably because high profile financial scandals of multinational corporations usually have an enormous negative impact on stakeholders ranging from loss of jobs and pensions to reduction in stock prices which affect shareholders' investments [12]. But the truth is that huge amount of money is lost to corporate accounting fraud globally. Reference [1] reports to the nations on occupational fraud and abuse estimated the cost of corporate fraud globally to be $3.7 trillion.

The Enron scandal of 2001, WorldCom, Adelphia and Tyco of 2002, Parmalat of 2003, Madoff of 2009 Barclays Bank of 2012, Tesco of 2014 and Toshiba of 2015 are all indications that corporate accounting scandals is a major problem that is on the increase globally in occurrence and severity [7], [24]. The frequency at which corporate entities collapse nowadays has raised a serious question on whether the current accounting paradigms of reporting and financial controls are working [23].

Reference [7] suggested that the corporate accounting scandals that have occurred during the last few years not only came as a shock, due to the enormity of the failures, but also that the discovery of these scandals questions the integrity and capabilities of the profession of auditing. The waves of the 21st century financial scandals have raised the awareness of fraud and the responsibilities of auditors in detecting those frauds [22]. There have been several attempts by the accounting standard setters and accounting regulatory bodies to increase the responsibility of auditors to consider fraud in financial statement audits. For example, the Sarbanes Oxley Act (SOA) of 2002 was one of the various attempts to solve the problem of financial statement frauds. The SOA of 2002 successfully increase auditors' responsibilities in relation to fraud prevention and detection in the financial statement and also

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separated the position of the Chief Executive officer (CEO) of companies from that of the Chief Financial Officer (CFO) [21]. However, the series of accounting scandals that have occurred after the passage of the SOA pointed out that the issue of financial statement fraud is far from being solved, and neither is it that increasing auditors' responsibilities without proper training in forensic accounting will help solve the problem. Reference [25] posits that being a good accountant does not mean one is a good forensic accountant. The training and the way transactions are looked at is different. Being a good forensic accountant requires the professional to possess a broad spectrum of skills and knowledge [25]. These broad spectrums of skills and knowledge are what make forensic accountants standout in the crusade against financial deception [14].

Reference [9] pointed out that one of the major contributors to the global financial crisis that occurred recently is financial statement frauds. He observed that financial statement fraud is a threat to the efficiency, liquidity and safety of both debt and capital markets.

There is evidence that the perception of the business community, government, regulatory authorities and even the courts is that a higher degree of expertise is required to analyze current complex financial transactions and events [13]. As a result of this, forensic accounting is required to be thrown into the forefront of the crusade against financial deception [22]. And looking at forensic accounting which involves the application of accounting, tax, auditing, finance, quantitative analysis, investigative mind-set and research skills, and an understanding of the legal process for the purpose of identifying, collecting, analysing, and interpreting financial or other data or issues in connection with litigation and non-litigation services [22], there might be some possible way out of the embarrassment financial statement fraud brings to the accounting profession.

C.Rationale for the Study

The embarrassment that financial statement fraud has brought to the accounting profession is a huge one as the median loss lost to financial statement fraud is over $400 billion [1]. Over the last two decades, the unrelenting series of embarrassing audit failures has brought doubt to the competence of the present day accountants and should stimulate a paradigm shift in accounting [5], [16].

Virtually all the financial statement frauds that have occurred in recent times were audited financial statements. And yet these frauds were not spotted in the process of auditing. It looks like the current accounting paradigm can no longer guarantee the prevention and detection of fraud in this information revolution age. The reoccurrences of financial statement frauds and audit failures made [26] to once state in his address to senior accounting students at the University of Texas, that "*people wonder, investors wonder, legislators wonder, they wonder what is it that auditors really do. They wonder what value auditors bring. My worry is that the profession of auditing (both internal and external) may someday become irrelevant to the capital market*".

The key concern of this study is how long will the accounting profession keep shying away from the responsibility of providing credible financial reporting, just as the courts have often argued in most accounting scandal cases that the cardinal objective of a financial statement audit is to certify that the financial statements are free from material misstatement resulting from either errors or fraud [9]. If care is not taken, just like [26] have warned the value audit place on financial statements may one day become irrelevant.

An argument that [5] put forward is that until present day accountants (particularly auditors of financial statement) are trained in the forensic accounting skills, ethics, principles and start acting like detectives, the way and manner in which fraud is hidden in nowadays complex financial transactions will continue to threaten the credibility of financial reporting and corporate governance.

With the increasing popularity and demands for forensic accounting services with respect to fraud prevention, detection and investigation, time may have come for a paradigm shift in accounting to forensic accounting. In order to protect the integrity of the profession, there is need to look for a more robust way of reducing the incident of fraudulent financial reporting in the financial statements. In a similar vein, [23] contends that an auditor's legal liability for not discovering their client's fraudulent financial actions is simply not going to disappear. It is hard to understand how the liability for undiscovered frauds or other malfeasance can be reduced by continuing to strongly rely on the present rule-based, auditing-reporting model. More so that research has constantly confirmed that preventing fraud and uncovering deceptive accounting practices are in strong demand as companies respond to closer scrutiny of their financial activities by shareholders and government agencies [15], [19].

Even [3] reasoned that there should be an increase in the use of forensic accounting procedures to detect fraud in the financial statement. Reference [3] contends that forensic accountants and external auditors have different mind sets. As such audit team need to be trained to incorporate more forensic accounting procedures into their audit practices and to retain more forensic specialists to help detect problems [3]. However, since that 2004, nothing has really changed. Reference [3] reasoning did not lead to any reform in the profession nor was any new standard introduced. This is because more revelations of fraudulent financial reporting came to the lime light and the profession of accounting is always being questioned after the revelation of any fraudulent financial statement. As such there need to move from mere arguments and contentions to practicality. And for this to happen, there is need to understand the perceptions of various stakeholders within the accounting profession. Hence, it is on this ground that this study was conducted by assessing the perception of some stakeholders within the accounting profession on whether a paradigm shift from mere reporting and procedural auditing to forensic accounting can help to reduce financial statement frauds. This needs to be done in order to protect the integrity and the future of the accounting profession and to meet the expectations and yarning of stakeholders (users of accounting information) in providing credible financial reporting.

D. Forensic Accounting

The term forensic accounting has been misconstrued by many as majority of the people think forensic accounting is all about fraud investigation [2]. While this is partly correct as fraud investigation is part of forensic accounting. But forensic accounting is much more than fraud investigation. As further observed by [27], there is a disconnection between the academic and professional perceptions of forensic accounting. Professors seems to think that forensic accounting is fraud detection, whereas practitioners understand that fraud is only a small part of forensic accounting.

If forensic accounting is much more than fraud investigation, then what is **forensic accounting?** The answer to this is that there is no generally acceptable definition of forensic accounting. Although all the definitions that have been given by various authors have something in common which is litigation and non-litigation support. Below are some widely used definitions of forensic accounting in literature:

According to [3], "*Forensic accounting is the application of accounting principles, theories, and discipline to facts or hypotheses at issues in a legal dispute and encompasses every branch of accounting knowledge"*.

To [2], *"forensic accounting is the use of professional accounting skills in matters involving potential or actual civil or criminal litigation, including, but not limited to, Generally Acceptable Accounting Principle; the determination of lost profit, income, assets, or damages; evaluation of internal controls; fraud; and any other matter involving accounting expertise in the legal system"*.

Emphasizing the relevance of forensic accounting in fraud prevention and detection, [28] stated that "auditors should be watchdog and not be the bloodhound". This quote alone is enough in making forensic accounting definition even simpler and help differentiate a forensic accountant from other accountants and auditors. Forensic accountant is a bloodhound of bookkeeping [27]. These bloodhounds sniff out fraud and criminal transactions in banks, corporate entities or from any other organization's financial records. They hound for the conclusive evidences. External auditors are known to find out the deliberate misstatement only but the forensic accountants find out misstatements deliberately. External auditors look at the numbers but forensic accountants look beyond the numbers [28]. These are some of the attributes that makes forensic accounting relevant in the fight against financial deception.

The field of forensic accounting was a growing specialism before the Enron and WorldCom scandals which led to the enactment of the Sarbanes Oxley Act [25], although many people think it is a new concept or specialization in accounting [27], it's history can be traced back to ancient Egypt where the scribes take inventories of Pharaohs' assets (grains and gold) to prevent and detect fraud. What the scribes did at that time was more than mere audit evaluation. They investigated any suspicion of fraud and then reported back to the king.

E.Differences between Forensic Accounting and Auditing

Although there are some distinct differences between forensic accounting and auditing, there is enough common ground to train and deploy auditors to serve on the front line of financial statement fraud [15]. However, recent studies have shown that forensic accounting specialists outperformed auditors in fraud related tasks [29]. Nevertheless, this does not suggest that external auditors are in any way inferior to forensic accounting specialists in terms of their education, training, experience and professionalism. In actual sense, there are some similarities between the two professionals. One of such similarities is that both are required to maintain a high degree of independence and objectivity; to be innovative; to avoid having any preconceptions and biases when evaluating evidence; to have in-depth knowledge of Generally Acceptable Accounting Principles as well as general business practice and processes [30].

Even though forensic accountants and external auditors may share some similarities, there still exist a major difference between the two professional. Their mission is different. While forensic accountants mission is to make an absolute determination about the existence and source of fraud by gathering and evaluating evidence and interviewing all parties related to an alleged fraud situation, the mission of external auditors is to examine whether the company's reported financial statements, taken as a whole, are stated fairly in all material respect in conformity with GAAP [31].

In the simple analogy offered by [31] to illustrate the difference between forensic accountants and external auditors, they likening external auditors to patrolmen and forensic accountants to detectives. Similar to external auditors, patrolmen circulate through their assigned districts with the objective of keeping peace in the community. Ideally, patrolmen would like to continuously patrol through every location in their districts, however, it would be both time and cost prohibitive for them to do so. Thus, to remain effective, patrolmen have to balance risk and expectations in order to determine whether to focus or expand their patrols. Unlike patrolmen, detective do not go on patrol. They are tasked to investigate whether a crime has been committed. To successfully accomplish their task, detectives would examine everything in the alleged crime scene to gather any clues that may help them solve the case. Crime investigation is time consuming and costly endeavour as detectives are expected to keep searching and piecing different clues together until they solve the crime. Reference [25] observed that being a good accountant or auditor does not imply that one will be a good forensic accountant. The training of a forensic accountant is different from that of the auditor and the way they both look at transactions is different.

II. Research Methodology

Neo-empiricist inductive analytical approach was adopted for this study. Neo-empiricism is a theoretical perspective that assumes the possibility of unbiased and objective collection of qualitative empirical data [4]. It is used to denote those management researchers who place reliance upon empirical evidence as capable of ensuring objective truth yet simultaneously reject the positivist idea of discovering law through deploying hypothetical-deductive method [17]. The term neo-empiricism is now used for management research where the collection of qualitative empirical data is used for the inductive generation of theory 'grounded' in observation [18].

The neo-empiricism paradigm follows realist ontology [11] i.e. there is a real world out there that exists independent of the mind and an objectivist epistemology i.e. there exists a world that is external and theory neutral. Neo-empiricism was chosen because the subjective realm of the research subject (Stakeholders in the accounting profession) is important to the theoretical explanation of whether a paradigm shift to forensic accounting has any chance of reducing financial statement frauds and it is possible to access and describe the subjective realm of the research subject and theoretically use it to explain aspect of behaviour, in an objective manner [11].

Through semi-structured interview, data was collected from forensic accountants, external auditors and accounting academics, all in the United Kingdom. Data analysis procedure follows that of general inductive analytical approach with the aid of Nvivo software. Semi-structured interview was utilized in collecting interview data from accounting academics, forensic accountants and external auditors in the United Kingdom. General inductive analytical approach was adopted in analysing the resulting data from this study with the aid of Nvivo software.

III. Discussion of Findings

Findings showed that accounting stakeholders (forensic accountants, external auditors and accounting academics) are equally bordered about the frequency at which cooperate entities collapsed which support the argument of [16]. While they believed that a paradigm shift to forensic accounting might be the right step in the right direction, they pointed out an important barrier to this paradigm shift which is cost. The question of will investors be happy for audit cost to increase is actually a big one which is outside the scope of this study.

Findings equally suggest that, there might be need to change some of the auditing standards. one of such is the International Auditing Standard 240 that places the sole responsibility for fraud prevention and detection on those charged with the management and governance of entities. The stakeholders interviewed believed that the prevention and detection of frauds should be a joint responsibility between those charged with the management and governance of entities and the auditors. Furthermore, one of the key findings of this research is in the area of skill gap of auditors. While it is not as if auditors cannot prevent or detect frauds, they are not necessity train to do so which suggest that there is need to upgrade the training of auditors and all professional accountants across broad to include some element of forensic accounting skills, ethics and principles.

IV. Conclusion

This study has been able to empirically prove that while it is not as if auditors cannot prevent or detect fraud in the financial statements, they are not necessarily trained and obligated to do so. The level of their training limits their capacity to prevent and detect frauds. The Accounting profession need to bear in mind that in this age of information revolution, for the profession to remain relevant to the capital market, there is need for constant improvement on the qualities and capabilities of accounting professionals and a paradigm shift to forensic accounting looks like the right path for the profession to follow. Bearing in mind the embarrassment financial statement fraud has brought to the profession.

Once the above are achieved (i.e. training auditors in the forensic accounting skills, knowledge, ethics, principles and procedures and forensic accountants are getting involve in audit engagement), that will have successfully shifted the accounting paradigm away from mere reporting and procedural auditing to forensic accounting. If all audits are approached in the forensic accounting procedures, then chances of fraud prevention and detection will be high. And by so doing, future financial causalities will be avoided and investors' confidence in the financial reporting process will be restored.

There is also the need to change the ISA 240 if the profession is serious about preventing and detecting fraud in the financial statement. Fraud prevention and detection ought to be a joint responsibility of both those charged with the management and governance of entities and statutory auditors in order to increase effectiveness.

This research has implication for accounting policy makers, accounting standard setters, accounting education, accounting professional bodies, legislation and accounting firms on the need improve the current accounting curriculum by adding some elements of forensic accounting into present day accounting curriculum. Legislation also have a role to play here, by making it mandatory for forensic auditing which is often informed by forensic accounting of public listed companies. By so doing the interest of users of accounting information will be protected and more reliance will be placed of audited financial statement. Further research can look into the cost associated with this paradigm shift to forensic accounting.

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