



Forensic Accounting Investigation and Prevention of Fraud

Chuanhui Liu

Chongqing University of Arts and Sciences, Chongqing, 402160

E-mail:1052940464@qq.com

Abstract. At the end of the twentieth century and the beginning of the twenty-first century, a series of abominable fraud incidents occurred around the world. Even the United States with a mature capital market also has fraud incidents in corporations one after another, such as those in WorldCom, and Enron Corporation, causing significant losses to enterprises and investors. As a result, fraud has gradually become an emphasis of people in theoretical and practical circles as well as a difficult challenge for everyone. This paper studies the investigation and prevention of fraud from the perspective of forensic accounting, intending to provide reference to the further investigation and prevention of fraud.

Keywords: fraud, forensic accounting investigation, forensic accounting prevention

1 Introduction

Fraud has always been a hot topic in the accounting industry, and the occurrence of a series of fraud cases has pushed fraud to the tip of the iceberg. Due to the covert and harmful characteristics of fraud, fraud has also become a hotspot for research in both the theoretical and practical fields. To safeguard the interests of the relevant stakeholders in the enterprise, it is necessary to carry out in-depth research on the topics related to fraud prevention to ensure the healthy and stable development of the enterprise.

2 Forensic Accounting and Fraud

2.1 The Emergence of Forensic Accounting and Fraud

Public and professional accountants had been engaged in forensic accounting services during World War II. It is the rampant fraud that led to the emergence of forensic accounting. Some scholars point out that forensic accounting is a fraud Audit, which also indicates that the appearance of forensic accounting is accompanied by fraud. Therefore, forensic accounting should play an important role in the governance of fraud.

2.2 The Role of Forensic Accounting in Fraud

Forensic accounting is not an independent social activity, and it involves investigation, identification, and judgment of the activities around the case of accounting issues. In the current forensic accounting in various countries, forensic accounting plays various roles, such as fraud prevention, discovery, investigation and evidence collection, loss quantification, and litigation support. Thus, forensic accounting can also play significant roles that audit does not have in fraud prevention, investigation, and fraud loss quantification^[5].

3 Forensic Accounting Investigations of Fraud

According to domestic and foreign research on forensic accounting, we draw on advanced techniques in various disciplines, including audit, the science of evidence, and criminal investigation. According to the characteristics of forensic accounting, we conclude that forensic accounting investigation generally follows the following process:

3.1 Recognition of Fraud Signs

Fraud signs refer to certain indications that all frauds exhibit, such as changes in the lifestyle, abnormal mental state, gambling, and other behaviors of the suspects. When fraud occurs, the investigator should begin to investigate and identify the behaviors of fraud suspects to find the signs of fraud and to provide the basis for further fraud investigation.

3.2 Identification of Fraud Motives

The factor analysis of the stress of fraud mainly focuses on whether there are factors that lead to fraud. Stress factors include unreasonable performance requirements in the corporation, unreasonable incentives, unsatisfactory business efficiency, and disagreeable interpersonal relationships.

The factor analysis of the fraud opportunities focuses on identifying whether there are factors that lead to fraud opportunities. It mainly includes whether there are unreasonable governance structures, whether the internal control is effective, and whether the supervision system is perfect.

The factor identification of fraud rationalization mainly focuses on the identification of ethical factors of fraudsters and is mainly carried out with the help of technical means such as reference checks.

3.3 Implementation of the Technical Survey for Forensic Accounting

The biggest difference between forensic accounting and audit is that the former draws on and uses the advanced technical means of other disciplines. It uses not only the tra-

ditional Audit technical means but also a collection of advanced means of various professional disciplines, including accounting, audit, and judicial majors. It also has more effective technical means to deal with fraud, including reference checking, data mining, questioning interviews, and monitoring surveillance.

3.4 Use of Evidence

Investigators, after the implementation of forensic accounting technical investigation, must identify and appraise the authenticity and probative power of the evidence, as well as mutual corroboration of the evidence and evidence of correlation analysis, and following the legal requirements of the form of custody of the evidence to ensure that the evidence of the lawfulness and reasonableness of the evidence by the requirements of the law.

In conclusion, forensic accounting integrates the advanced technical means of other disciplines, showing its very advantageous characteristics, which are more effective in dealing with the investigation of fraud, which is also an essential reason for the rise of forensic accounting^[4].

4 The Fraudforensic Accounting Prevention System Construction

Though fraud cannot be avoided entirely, we do not want to have fraud incidents. Thus, to reduce the losses caused by fraud, we need to take positive means and measures to prevent fraud as far as possible. Forensic accounting has more advantages in preventive measures to make up for the shortcomings of traditional measures. Next, we will analyze the shortcomings of traditional measures.

4.1 Analysis of Traditional Measures for Fraud Prevention

The fraud prevention measures in theoretical and practical fields mainly include corporate governance, internal control systems, internal audits, and independent audits. Due to various reasons, the measures all have their limitations with limited functioning roles.

(1) Corporation governance

Corporation governance, as an important system of supervision and checks and balances for enterprises, should serve as the first line of defense for fraud prevention. It is also an important control environment element for the internal control system. An effective and well-structured corporate governance framework serves a dual purpose. It not only serves as a robust system of checks and balances to safeguard the rights of all stakeholders, thereby playing a pivotal role in preventing fraud, but it also plays a crucial role in fostering a conducive control environment for the internal control system. This, in turn, ensures the efficient functioning of the internal control system and bolsters efforts to enhance fraud prevention measures. Nonetheless, the reasonableness of the corporate governance structure is subject to the influence of various factors, including

the composition of the shareholder base and the intentions of management. Consequently, corporate governance also exhibits its inherent limitations.

(2) Internal control system

The Securities and Exchange Commission (SEC) conducted a study of fraud cases from 1981 to 1986, and the results of the study indicated that internal control failures were a consistent fraud factor. The U.S. Congressional Commission and the Association of Certified Fraud Examiners (ACFE) also found the same result in their studies. In most of the fraud cases, companies had well-established internal control systems, but none of them functioned as they should.

The system of internal control has the following limitations regardless of how it is designed and implemented, and it can only provide reasonable assurance regarding the achievement of internal control objectives:

1) Human judgment errors and ineffective internal controls led by human errors

2) Circumvention by personnel collusion or by managers overstepping internal controls

(3) Internal audit

Traditionally, our perception of the primary functions of internal audits has been centered on activities such as financial audits and performance audits rather than emphasizing their role in fraud prevention. The poor independence of internal audits also leads to its minimal role in fraud prevention. Internal audit seldom digs deeper into the problems found and explores the issues behind them. Therefore, due to the positioning of the traditional functions, it does not play a proper role in fraud prevention.

(4) Independent audit

Independent audit, as an external force with better independence than an internal audit, is often given high expectations^[1]. However, this is not the case, and audit collusion often occurs. The new audit standards also make clear to consider fraud in audits by independent auditors. However, based on self-interested considerations, the auditors often resort to avoiding and terminating audit engagements when signs of fraud are detected.

All of the above means and measures to prevent fraud have certain shortcomings and deficiencies, and it is difficult to prevent fraud from occurring effectively on its own. This is not only due to institutional factors but also concerns about technical means and conceptual factors. To effectively prevent the occurrence of fraud, we should explore more effective measures and means. The rise of forensic accounting in foreign countries provides theoretical guidance for us to formulate fraud prevention measures^[2]

4.2 Establishment of the Position of Forensic Accounting

Forensic accounting started late in China with immature theories, and thus people's understanding of forensic accounting is still relatively shallow. Overseas countries have corresponding forensic accounting professionals, who play an obvious role in the detection, prevention, and investigation of fraud evidence. To play the role of forensic accounting in the prevention of fraud, it is necessary to define the establishment of the position of forensic accounting^[1].

In China, the field of auditing is categorized into three distinct categories: independent audit, internal audit, and government audit. Additionally, there is a need to carefully consider who should be responsible for performing these functions. Based on the observations made earlier, the unique relationship between independent audits and audited units can pose challenges in effectively detecting and preventing fraud. Therefore, it is our contention that the role of forensic accounting is best suited within the domain of internal audit.

(2) Transformation of internal audit to forensic accounting

Forensic accounting, as a discipline and profession originating in Western countries, has developed maturely abroad. However, in China, it is still in its nascent stages of development. As a discipline and profession that emerged with fraud, its characteristics and advantages that are different from those of auditing make it more effective in preventing fraud. According to foreign research data, it is generally believed that forensic accounting mainly has the following functions, discovery, prevention, investigation and evidence collection, loss quantification, and litigation support. Its scope of practice is notably wide-ranging.

We believe that it is a good choice for internal audit to take the position of forensic accounting, that is, to realize the change of the role from internal audit to forensic accounting. This view is based on the following considerations^[3]:

1. Since the internal auditor is the one who is most familiar with the internal situation of the enterprise, and the one who has closer contacts with the management and the enterprise's personnel at all levels, it is in a quite favorable position to discover fraud signs and take timely measures to prevent it.

2. The assumption of the function of forensic accounting by internal audit and the integration of forensic accounting into internal audit are consistent with the principle of secrecy in the detection, identification, and investigation of fraud. Incorporating forensic accounting-related procedures during normal internal audits avoids the need for alarm and allows the investigation process to be carried out in secret without being detected by the investigator^[1].

3. The rise of forensic accounting is largely related to the softening of the audit function and the limitation of audit tools. Therefore, to adapt to the requirements of economic development, the expansion of the functions of the internal audit to forensic accounting has been inevitable, which is also in line with the inevitable trend of internal audit from "supervisory" to "service" change^[1].

4.3 Specific Construction of a Fraud Prevention System

Forensic accounting, as a discipline and profession originating in Western countries, has matured abroad but is just starting in China. As a discipline and profession that accompanies the emergence of fraud, the characteristics and advantages of forensic accounting that are different from those of audit make it more effective in fraud prevention.

(1) Preventive concept of forensic accounting

Forensic accounting prevention focuses on continuous and uninterrupted prevention before, during, and after the event, internal and external coordinated prevention, and

the combination of tangible and intangible prevention, which further highlights the characteristics and advantages of forensic accounting techniques in fraud prevention. Prevention beforehand mainly refers to conducting reference checks to reduce moral risks; prevention during the process mainly refers to the monitoring of activities and behaviors through corporate governance, internal control systems, and internal audits; and prevention after the event mainly refers to analyzing the deficiencies of a company's fraud prevention to formulate more effective preventive measures. Internal and external coordination of prevention mainly means that the prevention of fraud requires not only internal forces but also forces from the outside, such as the establishment of hotlines for reporting. The combination of tangible and intangible refers to the coordination of the company's normal channels as well as non-regulatory measures of prevention, including the prevention of the company's rules and regulations and the human environment of the company. This concept provides new ideas and perspectives for effective fraud prevention. Since forensic accounting started late in China, it is of great practical value to introduce forensic accounting into the fraud prevention system.

(2) Construction of a prevention system from the perspective of forensic accounting

By the forensic accounting prevention concept, we have constructed a new prevention system for fraud so that it can function accordingly. The new prevention system is shown below figure 1: Illustration of the fraud prevention:

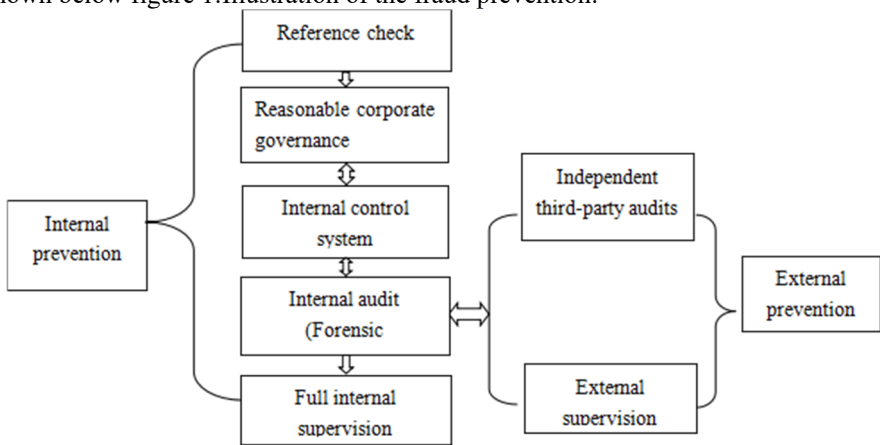


Fig. 1. Illustration of the fraud prevention system

The first line of defense against fraud prevention is to check the employers' pre-employment reference and corporate governance bodies, which detailed background investigations through file records, interviews at previous workplaces, and other means can be conducted to evaluate their personal qualities and information such as ethical standards and work attitudes; the checking and balancing of authority through the development of a reasonable corporate governance structure constitute the prevention of fraud. The second line of defense is internal control. The third line of defense is internal audit. The second line of defense and the third line of defense constitute the control during the event. The last line of defense is the independent audit and external reporting,

which is the so-called after-event prevention. If the previous lines of defense are not effective in preventing fraud, the last line of defense can still play a role in reducing the loss of fraud because fraud generally lasts for a longer period before it is detected, and active after-event prevention is equally important.

(3) Support for the prevention system

The most distinctive feature of this system is that we make the internal auditor act as a forensic accountant by training internal auditors to become forensic accountants. Internal auditor carries out reference checks and daily supervision, as well as liaison and coordination with external forces. To empower internal auditors to fully leverage the benefits of forensic accountants, the initial step is to provide robust systemic support, ensuring that internal auditors operate without undue influence or interference. Enhancing the independence of internal auditors is crucial to harnessing the significant advantages of forensic accounting in fraud prevention, reducing fraud occurrences, and fostering a conducive environment for economic development.

5 Conclusion

Forensic accounting is one of the most emerging disciplines. It has been developed and matured in overseas countries, but in domestic, it is still in its infancy. There are many vacuum areas, but the vital role forensic accounting plays in fraud investigation and prevention requires further exploration and research.

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