



# The impact of forensic auditors in corporate governance

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## Abstract

The incessant financial Fraud resulting to corporate collapse and the failure of the statutory audit to detect and prevent fraudulent activities which had led to the impoverishment of investors had given rise to the need for forensic auditor. In view of the above this paper considers the impacts of forensic auditor on corporate governance. The study was a theoretical research which considered the roles of forensic auditors in combating fraudulent activities, distinction of forensic auditor and statutory auditor, characteristic of forensic auditor and impact of forensic auditor on corporate governance. From studies carried out this paper concludes that forensic auditors having improved management accountability, strengthened external auditor, independence and assisting audit committee members in carrying out their oversight functions by providing them assurance on internal audit report have impacted positively to corporate governance, thereby reducing corporate failure and impoverishment of investors.

**Keywords:** Forensic Auditors; External Auditors; Financial Fraud; Statutory Audit

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## **1. Introduction**

### **1.1. Overview of the study**

The incessant financial fraud and its impact on corporate performance has led to the need for multi-dimensional relationship (that is inter-relationship between the audit committee, the external auditor and the management) in corporate governance as to protecting the interest of shareholders and other market participants with the common goal of improving oversight function and ensuring good corporate governance (Deloitte and Touch, 2006).

However, in spite of the multi dimensional relationship between the three major groups in corporate governance, financial fraud which had led to poor performance and most times to corporate collapse resulting to huge lost of investment and impoverishment of many investors has continued to be on increase (Rezae, 2005). Ramaswamy (2009) states that the failure of the corporate structure has made the financial community realize that there is a great need for skilled professionals that can identify, expose and prevent weaknesses in three key areas: poor corporate governance, flawed internal controls and fraudulent financial statement, has led to increasing forensic accounting skills. According to Owojori and Asaolu (2009), failure of statutory audit to prevent and reduce misappropriation of corporate fraud and increase in corporate crime has put pressure on the professional accountant and legal practitioner to find a better way of exposing fraud in business world has led to the need for forensic audit.

The above problems have posed serious concern to the accounting profession, and users of accounting information, thus giving rise to the call for forensic auditors. In view of the above, this study aims at ascertaining the role of forensic auditor and its impact in corporate governance.

## **2. Statement of the problem**

The failure of the major corporate governance mechanism to reduce financial fraud and the increasing sophisticated financial fraud has posed serious threat to investors, government, and general public (Eyisi and Agbaeze, 2009). Moreso, the stakeholders of most companies are worried over the unqualified audit report being certified by external auditors and few weeks after such reports are been certified such companies are found to be in serious financial crisis leading to bankruptcy and most times liquidation, thereby impoverishing the investors and affecting the economy (Aneto, 1993). An instance of case of corporate financial statement audit fraud could be drawn from Enron and WorldCom which has capitalized expenses resulting to increased profit which is not in existence by their auditors Andersen and yet such companies audit was unqualified by their auditors resulting to corporate failure of two big companies in USA (Zimbelman et al., 2012).

Moreso, the Federal Bureau of Investigation (FBI) (2007) report estimates that fraud in non-health insurance costs more than \$40 billion per year, or put another way, costs the average U.S. family between \$400 and \$700 per year in increased premium.

Other, instance of corporate financial fraud could be drawn from recent bank failure in Nigeria where management has fraudulently given loans without board approval and yet such bank annual report has been unqualified. From the above it could be said that the external auditors have continued to certify fraudulent financial statement as unqualified audit report thus, resulting to impoverishment of investors and most times corporate collapse and economic crisis. Since the external auditors has refused to accept the responsibility of detecting financial fraud, rather has claimed to be only responsible of laying credence to financial statement this has created a gap between the users of accounting information and accounting profession. This gap is known as Audit Expectation gap (Adeniji, 2004; Ekwueme, 2000). Hence, the failure of statutory audit to prevent and reduce fraudulent activities in corporate governance had necessitated the need for forensic Accounting (Owojori and Asaolu, 2009).

In view of the above problems, this study examines the role of forensic auditor in combating fraudulent activities and its impact in corporate governance.

### 3. Objective of the study

In view of the above problem this study considered the following;

- Examining the roles of forensic Auditor in combating fraudulent activities in corporate organization.
- Determining the characteristics required by forensic auditors as to combat fraudulent activities.
- Differentiating between Forensic Auditor and Financial Auditor.
- Ascertaining the impact of forensic auditor in corporate governance.

### 4. Literature review

#### 4.1. Concepts of forensic auditor

The term forensic means “relating to the application of scientific knowledge to legal problems or usable in a court of law” (Bolgana and Robert, 1985). According to Singleton 2004, Webster dictionary defines forensic as belonging to; used in, or suitable to courts of judicature or to public discussions and debate. Thus, from the above definition it could be said that forensic Auditors are experts in financial matters who are trained in detecting, investigating and deterring fraud and white collar crimes which are to be presented to court for legal action or to public discussion and debate. This is in line with (Messier, 2000) definition which states that forensic auditors are fraud examiners employed by corporations, government agencies public accounting firm and are trained by Association of certified fraud examiners (ACFE) on areas which covers, fraudulent financial transactions, legal elements of fraud investigation, criminology and ethics.

Singleton and Singleton (2004) stated that forensic accounting is one of the oldest professions and dates back to the Egyptians. The *eyes and ears* of the king was a person who basically served as a forensic accountant for pharaoh, watchful over inventories of grain, gold and other assets. From the above definitions

it can be said that forensic auditor are financial experts which use and applies scientific knowledge to detect fraud and crime in legal matters, which may be criminal or civil disputes.

According to AICPA (2008) forensic Accounting services generally involve application of special skills in auditing, accounting, quantitative methods, finance, specific areas of the law, information and computer technologies research and investigative skills to collate, analyze, and evaluate evidential matter which in the forensic area is called the evidence. From the above it could be said that forensic auditor possess expertise skill and can be called to carry out investigation on financial matter which may be used in law court and also he can be called to act in the law court to give evidence on issues relating to financial fraud.

## 5. Activities being carried out by forensic auditors

Cabole (2010) defines forensic activity as the activity that consists of gathering, verifying, processing, analyzing of and reporting on data in order to obtain facts and/or evidence in a predefined context in the area of legal financial disputes and or regulative (including fraud) and giving preventative advice. From the above one can say that a forensic auditor is an expert in accounting with experiences and special skill in Auditing, fraud detection and criminology that carries out investigation which is usable in the Law Court. In order to understand activities been carried out by the forensic auditor there is need to know the objective of forensic audit.

## 6. Objectives of forensic audit

The objectives of forensic audit will help us to understand the role of forensic auditor and its impact on corporate governance. These objectives are;

- To improve management accountability.
- To improve corporate governance and the statutory audit function.
- To improving financial reporting system.
- Help in detecting financial fraud.
- Help in strengthening auditors independence
- Providing additional assurance for audit committees.
- Assists financial statement auditors to take greater responsibility for the detection of fraud and illegal acts when auditing financial statement due to the fact that another set of auditors (forensic auditors) would be critically evaluating their role.
- Gives the audit committees better tools to evaluate the quality of the financial statement audit by the external auditor.

The above objectives could be said to have stronger impact on corporate governance, since the forensic auditor is expected to go beyond normal audit as to search for fraud and investigate deeper using more sophisticated scientific analytical tools and software packages to detect fraudulent activities perpetrated by

the management and their employees or fraud which the external auditor has conceivably connived with the management to cover.

## 7. Differences between forensic auditor and financial auditor

The differences between forensic auditor and financial auditor can be shown as below:

<p>Forensic auditor or Non-statutory auditor is employed or appointed by organization to resolve allegations and detect or prevent fraudulent activities suspected or envisaged in the organization. Thus, Forensic auditors carry out investigation as to resolve allegations on fraudulent financial matters through court. Thus, it is not a normal audit but audit which may or may not follow auditing procedures and GAAP in carrying out its function. Zimbeldam et al. (2012) states that, such audit is a proactive audit which goes beyond normal audit procedures.</p>	<p>Financial auditor or statutory auditor is usually appointed to carry out statutory audit. The financial audit is usually carried out to satisfy statutory requirements, and ensure that accounts prepared/maintained are in line with GAAP. Millichamp (1990), states that the statutory audit is a compulsory audit which ensures that financial statements are in line with GAAP. From the above, it can be said that statutory auditor may or may not go beyond the procedural audit since he is not compelled by law to search for fraud but rather in carrying out its audit function if fraud is detected he will unveil it.</p>
<p>Forensic audit is directed at specific allegations- Forensic Auditors carry out investigation on specific allegations. Hence he has much time to investigate and analyze thoroughly specific fraudulent financial issues with emphasis of using such as evidence in law court in case of dispute (Albrecht and Albrecht, 2009).</p>	<p>Financial audit carried out by the financial auditor is general in nature. According to Millucky and Mac (2013) Financial audit is carried out on general financial matters. (that means the auditor considers all issues which concern all relating to accounting).</p>
<p>Forensic Auditor is not apt to accept explanations and documents at face value – Forensic Auditors are not apt to accept explanations and documents at face value. (Cole 2009). From the above the forensic auditor is expected to always go beyond the normal audit and search for fraud which are to be reported to who so ever have appointed the forensic auditor or to be used as expert evidence in the law courts.</p>	<p>Financial auditors usually do not burrow deeper into documents and explanations – This means that financial auditors usually do not carry out detailed analytical study of financial documents and explanations rather they try to lay credence that accounts prepared by management and their employees are in line with GAAP and statutory regulation (Cole, 2009).</p>

## 8. Responsibilities of forensic auditors in combating fraudulent activities

The forensic auditors or fraud auditors have the responsibilities that are listed below:

### 8.1. Conducting investigation

The forensic auditor does not carry out procedural audit, but carries an audit which conducts investigation as to detect fraud or crime using computer programs or scientific knowledge. This means the forensic auditor should have the capability to use computer forensic tools that could be both software and hardware in carrying out its function as to detect or prevent fraudulent activities. Thus by using the computer forensic tools in carrying out his responsibilities, sophisticated fraudulent activities can be combated. Owojori and Asaolu (2009), states that the failure of the statutory audit and the sophisticated financial fraud had led to the need for forensic audit. Thus, the forensic auditor could be said to have special tool for conducting investigation as to detect and prevent fraudulent activities thereby combating financial fraud. An example of software packages used to combat fraud is caseware software. Zimbelman (1997), states that being a fraud investigator is very much like being a physician, it requires significant amount of diagnostic and explanatory work to discover what is really happening. In view of the above it can be said that the forensic auditor goes beyond the normal audit as to unveil fraudulent activities using forensic software tools in conducting and investigating transactions and events.

### 8.2. Analyzing financial transaction

Forensic auditor in carrying out his function analyzes financial transaction involving unauthorized transfers of cash between companies (Owojori and Asolu, 2009). Cole (2009), states that the forensic auditors are required to have special skills in inspecting documents for authenticity, alteration, forgery or counterfeiting. Hence, by possessing such skills, the forensic auditor in carrying out his duties can easily detect errors, fraudulent activities and omissions thereby preventing and reducing fraudulent activities. Zimbleman et al. (2012) states that the forensic auditor is responsible for analyzing, identifying the kinds of fraud that could occur and their symptoms. Thus, since forensic auditor is a fraud detector that has the capabilities to analyze financial transaction which will help him to easily detect errors, fraudulent activities and omissions that may be presented for litigation or sent to the audit committee as to enable audit committee to evaluate the quality of financial statement audit.

### 8.3. Reconstruction of incomplete accounting records

The forensic auditor in carrying out his function reconstructs incomplete accounting records as to settle insurance claims, over inventory valuation, proving money laundering activities by reconstructing cash transactions (Owojori and Asaolu, 2009).

In order to combat fraudulent activities, the forensic auditor with his skills (Technological, communication and expertise skills) in accounting knowledge can reconstruct incomplete accounting records, hence helping to detect and prevent fraud and ensuring good internal control system and good corporate governance.

#### 8.4. Embezzlement investigation

In carrying out embezzlement investigation and providing documentation, and negotiation of insurance settlements the forensic auditor uses his special skill and experience, thus helping to detect the culprit and amount embezzled. Cabole (2009) and Wallace (2009) states that what forensic auditors do the followings:

- Fraud detection, documentation and presentation in criminal trials and claims.
- Calculate economic damages; trace income and assets, often in an attempt to find hidden assets or income.
- Reconstruction of financial statement that may have been destroyed or manipulated.
- Expert witness.

The above responsibilities listed by Cabole (2009) and Wallace (2009) shows that the forensic auditors must be specialist (experts) in financial matters and must have legal knowledge which could enable him detect fraudulent activities which are to be presented in the law suit. This is in line with Owojori and Asaolu (2009) views, which states that the major contribution of the forensic accountant is to translate complex financial transactions and numerical data which has been tampered into terms that the ordinary lay persons can understand. The above responsibilities carried out by the forensic auditor requires that the forensic auditor being a fraud fighting professional possesses certain characteristic which enables him to carry out his responsibilities effectively.

### 9. Characteristics of forensic auditors

The forensic auditors should possess the following characteristics as to enable him detect fraudulent activities which have been perpetrated by the management and their cohorts.

#### 9.1. High level of competence

The forensic auditors since his task is to detect financial fraud, he is expected to be an expert in accounting and also in detecting financial crimes and criminal issues using specialized computer programs of which he must be well competent. Thus, the forensic Auditors is expected to have undergone specialist training in Accounting, Auditing, Criminology, sociology and fraud investigation (civil and criminal) (Association of certified fraud examiners, 2008). From the above it can be said that the forensic auditor is not only a professional in accounting but also have knowledge in other fields of study which enables him to carry his function effectively. Wallace (2009) listed the minimum requirement a forensic Accountant must possess to include:



- An ability to review a large volume of documentation ranging from the more usual accounting records and management information system to memos, correspondence and other less obviously financial data and to extract the key issues quickly.
- A sound understanding of peculiarity of various business methods.
- A sense of urgency and commitment which will ensure prompt response when required however slow civil litigation may appear to the on looker or even to the participant's in a dispute.
- Adherence of strict time table even when needs arises to work for more hours to meet targeted time.
- Most essentially, an ability to appear objectives and professional even when taking part in the inherently partisan process of a court case.

From the above it could be said that forensic auditors are expected to possess analytical skill, communication skill and technological skill. These skills are special skills which enable the forensic auditor to combat fraudulent activities.

## 10. Special skills possessed by the forensic auditors

The forensic auditor requires special skills in auditing, accounting quantitative methods, finance specific areas of the law, information and computer technologies, research and investigative skills as to be able to collate analyze and evaluate evidential matter which in the forensic area is called evidence (Forensic and compliance institute, 2009).

### 10.1. Communications skills

Forensic auditor should have a good interactive skill. According to Nathan (2009) the forensic auditor to detect fraudulent activities requires special skills which includes;

- Be good a interviewer
- Having Ability to observe behavior especially during interviews
- Ability to Reconstruct financial transaction through information obtained from the parties
- Know the legal implications of evidence obtained.

### 10.2. Technical/financial skill

The most important skill required by forensic auditor as to detect fraudulent activities is solid technical accounting and financial skill (Cabole,2009). The forensic auditor without technical accounting knowledge and competence in financial issues may not be able discover conceived considered fraudulent activities perpetrated by the management and their employees. Hence, technical and financial skill is of great importance in carrying forensic audit functions.



### 10.3. Analytical skill

This is the ability to analyze complex financial transaction using expertise intuition to detect fraudulent activities and to perform effective analysis of financial transaction.

### 10.4. Investigating skill

Investigative skill is the ability highly needed by the forensic auditor to search for fraudulent financial acts, errors and misstatement. According to Owojori and Asolu (2009), Investigative skills would include areas such as the ability to assimilate large volumes of information, general organization and administration skills, use of the microcomputer or understanding the abilities of the microcomputer, and interpersonal skills.

### 10.5. Honesty and High integrity

Since the forensic auditor is expected to detect fraud, he is expected to be of high integrity and honesty in carrying out his functions. According to CPA (2009) the forensic accountants are vital allies in the fight against fraud and provides assistant to the Audit committee hence he is expected to show high integrity and honesty in carrying out his function.

## **11. Impact of forensic auditor in corporate governance**

### 11.1. Improve management accountability

Management is accountable to shareholder, and other stakeholders. Management of companies are said to be solely responsible for preparing Accounts and maintaining adequate proper financial records (Millichamp, 2002). Moreso, they are responsible for detecting and preventing fraud in their organization which may not be unveiled by the statutory auditor, while the external auditor responsibility is to ensure that account prepared by companies management are in line with general accepted accounting principle (GAAP) and statute. However the external auditors in carrying out their duties may unveil fraud if such is discovered. The external auditor has refused to accept responsibility to detect fraud. Although the SAS 55 has required the external auditor to report material misstatement and errors arisen due to fraudulent activities.

Nevertheless, the above responsibility functions have not been achieved; thus resulting to corporate fraud and most times corporate failure and poor corporate governance. In order to ensure proper accountability and prevent fraud by the management the forensic auditor been an expert in financial fraud matters with special skills in scientific knowledge and legal matters have helped management to improve their role by providing software packages which enables management to easily detect and prevent fraudulent activities . Also, since management are aware that the forensic auditor may be called upon by shareholders/External auditors and audit committee at any time to investigate and detect financial fraud, the management will be more diligent in carrying out its function effectively knowing full well that the forensic auditor is a crime

detector. The directors being aware that the forensic auditors may be invited to detect and prevent fraudulent activities, they will most time ensure that their organization has a good internal control system, checks and balances which are transparent, thereby positively influencing corporate governance.

Ramaswamy (2009) states that the failure of the corporate communication structure has made the financial community realize that there is a great need for skilled professionals that can identify, expose, and prevent weaknesses in three key areas: poor corporate governance, flawed internal controls, and fraudulent financial statement. Forensic accounting skills are becoming increasingly relied upon within a corporate reporting system that emphasizes its accountability and responsibility to stakeholders. From the statement Forensic Auditor with his expert knowledge in crime will help to improve corporate reporting system designed by management which will expose and prevent poor governance, flawed internal control and fraudulent financial statement.

### 11.2. Improve corporate governance and statutory audit function

Statutory Audit is an audit required by law as to lay credence to financial statement and ensure that adequate and proper financial records have been maintained as required by statutes and GAAP and regulations.

However, the external auditor in carrying out audit function has not been able to carry his function effectively due to its mode of appointment. The external auditor by law is required to be appointed by shareholders, most times the management on behalf of the shareholders appoint the external auditor whose book of account is being examined (audited). Thus, auditors most times, may not report cases of fraud perpetrated by the management to the shareholders (owners). In view of the above it can be said that the mode of appointment of the external auditor has negatively affected external auditors performances in carrying out its corporate governance function effectively thereby making investors to lose confidence in annual corporate reports of companies (Lee and walker, 2001). An instance of this could be draw from Arthur Andersen of Enron and world Com. auditor who were indicted for obvious fraudulent financial statement which affected investors and economy of U.S. (Zimbleman et al, 2012). Nevertheless, the issue of fraud in corporate governance can be reduced due to use of forensic auditor. The forensic auditor with his special skills (that is Analytical, Communication and Technological skill) can reduce fraud and improve corporate governance by in stilling fear both to the management and their employees when carrying out his audit function. Moreso, the external auditor been appointed by management will no more have fear in reporting fraudulent activities performed by management and their employees, since he has the right to assign material misstatement due to fraud to the forensic specialist. According to SAS 99 external auditors are provided guidance that has the potential to improve audit quality in detecting material financial misstatements, whether caused by fraud or error. SAS No. 99 includes the suggestion that an "auditor may respond to an identified risk of material misstatement due to fraud by assigning forensic specialist (AICPA 2002). From the above, the forensic auditor may improve corporate governance and statutory audit function by using specialist skill to help statutory auditor to detect fraudulent activities which the external auditor may not discover as he has no expertise skill and knowledge in detecting modern sophisticated fraudulent activities in organizations.

### 11.3. Strengthening auditors independence

Most times external auditors are afraid to report case of fraud committed by management to the shareholders even when such fraud is obvious .Thus this impairs auditors independence as they are usually afraid to lose their job since most times they are been appointed by the management who prepares accounts that is also being audited (Albrecht and Dunn, 2001). According to Albrecht (2001) Improving financial reporting system with expertise knowledge and skill in both financial matters, the forensic financial reporting system through use of proactive method of fraud detection have strengthened external auditors independence , hence improving corporate governance. From the above it could be said that the use of forensic auditor tools acts as guide to the external auditor in carrying out statutory audit functions and thus this has strengthened auditor independence.

## 12. Assist audit committee member

Forensic auditors assist audit committee members in carrying out oversight functions by providing better tools to evaluate the quality of the normal financial statement audit produced by the external auditors. According to Zimbelman et al. (2012) the forensic auditor in carrying out his responsibilities of controlling fraudulent activities use data driven fraud detection tool which is proactive unlike the traditional approach which is reactive and is been adopted by the external auditor in carrying statutory audit functions. Some of the data analysis software used by the forensic auditor are ACL Audit Analytics, Case ware ideas and Picalo. These software analytical tools are detectlect which not only detect fraud but also tries to search symptoms of fraud (Albrecht and Dunn, 2001). The above tools conceivably enable the audit committees members to ensure that quality assurance audit report have been produced by the external auditor (who lay credence to financial statement) and management who are charge with the responsibilities of preparing accounts, detection and prevention of fraudulent activities thereby creating good accounting system controls (internal control). More so, since the external auditor and internal auditor are aware that organization may at anytime appoint or employ a forensic auditor to help to investigate and detect financial fraud there is greater responsibility to financial statement auditors to diligently and effectively carry out his functions and report on fraudulent activities observed this thus, will enhance good governance.

## 13. Helping in detecting financial fraud

With the use of analytical and technological skill, the forensic auditor can easily detect financial fraud perpetrated by management thereby preventing corporate failure and ensuring good corporate governance. Cleary and Thibodean (2005), states that the forensic auditor knows how to detect and prevent business fraud using Benford law (a fraud analytical digital tool). Thus, from the above, it could be said that forensic auditors in helping to detect and prevent fraudulent activities could be seen to have helped organizations in reducing financial fraud which most time had led to corporate collapse.

The external auditors are given greater responsibility for detection of fraudulent activities and illegal acts when auditing financial statement. This greater responsibility will help to improve corporate governance which ensures that corporate objective is been achieved or improved. Previously, the external auditor in carrying out his audit functions has refused to accept responsibility for fraudulent activities. More so, greater responsibility have been assigned to external auditor according to SAS 99 which suggest that auditors can assign forensic specialist where identified risk of material misstatement has arisen due to fraud. Hence, the forensic auditors are expected to use their expertise skill to help external auditors detect fraudulent activities which has arisen due to material misstatement.

## 14. Conclusion

Since the forensic auditors possess special skill and knowledge which can easily detect and prevent fraudulent activities, this definitely will be enabled the corporate governance mechanism (external auditor, audit committee and management) in carrying out their responsibility of achieving corporate goals and reducing financial fraud. Thus, the forensic auditor could be said to have impacted effectively to the corporate governance of the organization by improving the management accountability, and financial reporting system, strengthening independence of the external auditor, assisting audit committee members in their oversight functions by providing additional assurance and giving greater responsibility to the external auditor in carry out their statutory audit functions. Thus, this will definitely help to reduce corporate collapse and impoverishment of investors thereby influencing corporate growth and achievement of overall corporate objectives.

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