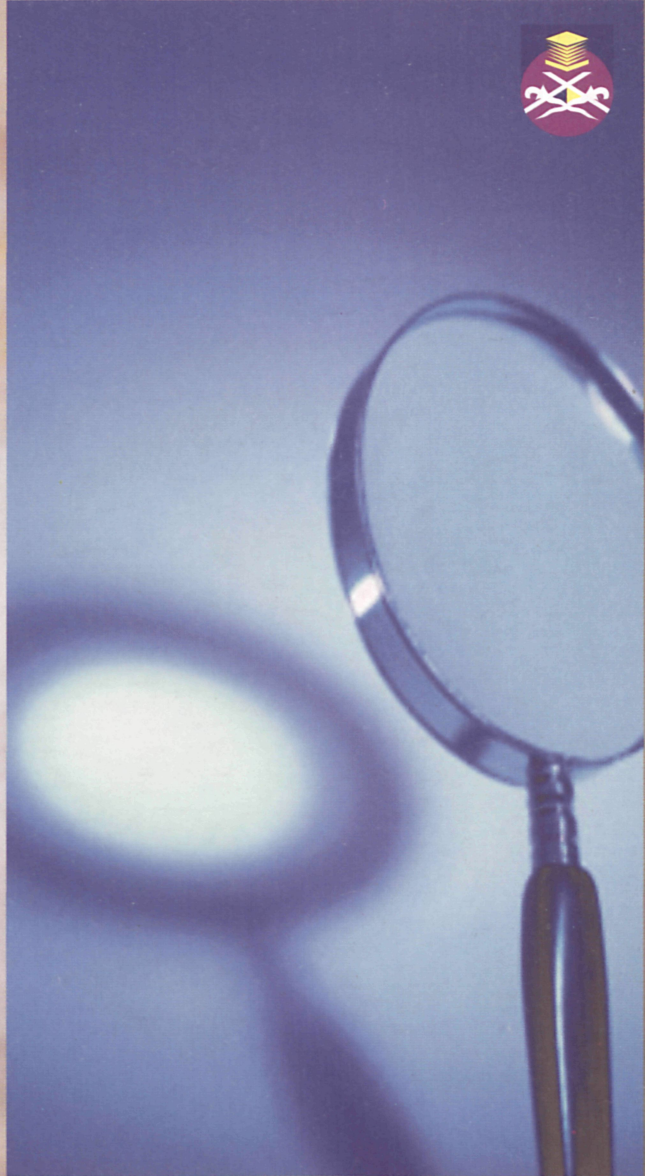


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*A Forensic Accountant is the financial detective and a witch doctor of the modern world. Lord Justice Harman, (Miles v Clarke {1953} 1 WLR 537 and 539)*

#### ABSTRACT

*Forensic Accounting (1) introduced briefly FORENSIC AND INVESTIGATIVE ACCOUNTING, the need for forensic accounting, definition of related terminologies, what forensic accountants do, typical approaches to forensic accounting assignment, characteristics of a forensic accountant, the litmus test and the seven deadly sins of fraud perpetrators.*

*Forensic Accounting (2) deals with FRAUD. This issue is given substantial consideration, as forensic accounting often involves allegations of fraud. The article is not intended to be exhaustive consideration of the topic, but an endeavor to justify the essence and understanding of fraud.*

#### INTENTION OF THE ARTICLE

The intended colloquium article is designed for the following distinct audience:

1. those of you who need the enlightenment and awareness on the subject matter, thereby ensuring that the understanding, the expectation gap is narrowed,
2. those of considering the possibility of attempting to become forensic accountants,
3. those of you who would be spurred to undertake research on the subject,
4. those of you who belong to the faculties of accounting, auditing, taxation, management, considering utilizing forensic accounting as a 'tool' towards achieving a broad understanding of a management disciplines, developing strong interpersonal skills, and develop analytical skills.

#### WHAT IS FRAUD?

Spielman (1995) says, Fraud involves direct or intentional misrepresentation or omission of a material fact. The term "fraud" is used extensively in litigation in both civil and criminal cases. Fraud is an element of many criminal offences and civil wrongs and consequently there is no offence of fraud per se. Instead, the law makes provisions for offences and wrongs committed fraudulently or involving an element of fraud.

Brennan & Hennessy (2001) state that normally the law punishes offences and wrongs that involve fraud more heavily than those that do not. For example, penalties for offences resulting in underpayment of taxes are doubled in many cases where fraud is involved (Income Taxes Act 1967).

Thus, the word “fraud” is commonly used as an umbrella term to cover a multitude of offences which may differ markedly in size, varying from very small e.g. false expense claims) to very large (e.g. fictitious overseas subsidiary).

Motivators for fraud are various. Opportunities for fraud can depend on the control environment in the organization. The work environment has a significant effect on the likelihood of fraud. Hiring of honest staff, valuing honesty highly in the corporate culture, treating staff fairly and having high codes of ethics all help to prevent fraud. Regular monitoring and enforcement of internal controls will assist prevention of fraud.

#### DEFINITION OF FRAUD

No statutory definition of fraud exists. Instead, the legislature intentionally leaves this question of interpretation to the courts. Huntington and Davies (1994) point out:

“English law does not define fraud. However, Buckley J’s description in *Re London and Globe Finance Ltd* (1903) encapsulates the two key elements: ‘to defraud is to deprive by deceit’”.

In fact, Buckley J. described fraud in the context of deceit and a fuller extract from his judgment provides a better appreciation of the meaning of fraud. He said:

“To deceive is, I apprehend, to induce a man to believe that a thing is true which is false, and which the person practicing the deceit knows or believes to be false. To defraud is to deprive by deceit: it is by deceit to induce a man to act to his injury. More tersely it may be put, that to deceive is by falsehood to induce a state of mind: to defraud is by deceit to induce a course of action.”

In this regard, deception is, for the purpose of this study, a person deceives if he or she – (a) creates or reinforces a false impression, including a false impression as to law, value or intention or other state of mind,

(b) prevents another person from acquiring information which would affect that person’s judgment of a transaction, or

(c) fails to correct a false impression which the deceiver previously created or reinforced or which the deceiver knows to be influencing another to whom he or she stands in a fiduciary or confidential relationship,

and references to deception shall be construed accordingly.

Huntington and Davies (1994) considered that any fraud would have two essential elements. There must be: (i) an attempt at concealment or deception; and (ii) there must have been some loss in the form of deprivation of funds or assets. In practice, it can be difficult to establish that there has been some dishonesty. On the other occasions, deception will be obvious but it will not be easy to show that it has direct financial consequences.

The definitions of fraud vary – five other alternative definitions exist, those by – French (1985),

Comer (1998), HM Treasury Fraud Report (1995), Auditing Practices Board (1995), MacGregor and Hobbs (1998).

The actual identification of a transaction as a "fraud" adds to the problem of its definition. Levi (1987) has pointed out:

"...fraud does present some special problems, because it offers the possibility of inducing into the victim an erroneous interpretation of what has happened. The victim may believe that he or she has been unfortunate or has made a commercial misjudgment: capitalism, after all, is taking risks and profiting or losing by one's risk-taking. Victims may even remain unaware that they had lost money at all."

The classification of an action as being fraudulent may depend on the motivation behind it (e.g. was it deliberate or accidental?). Burns (1998) asks "at what point does sharp practice become fraud?". This seems to imply that the dividing line between the two, in certain circumstances, may be fine. Oakes and Standish (1996) considered that:

"As fraud is the product of deception, it follows that estimation of its incidence is subject to significant error, with the true but unknown extent of fraud greater than detected fraud. In turn, detected fraud is greater than the extent of successful criminal prosecutions and civil damages for fraud, where the difference comprises fraud events on which companies take no action toward prosecution or recovery, and of unsuccessful actions. Detected fraud events within companies not followed by prosecution or recovery actions may nevertheless provoke dismissal or diminished career prospects."

Higson (1999) has also pointed to the difficulties arising from the absence of a definition of fraud, pointing out that the imprecision of the term may limit its usefulness in drafting any future legislation.

#### LEGAL PERSPECTIVES ON FRAUD

Fraud is not a legal term of art and is therefore ascribed its ordinary meaning by courts. As already pointed out, there is no all-embracing offence of fraud. Thus, it is not in itself a criminal offence to commit a fraud on a person. However, the words "defraud" and "fraudulently" are used in both common law and statutory offences, with the result that certain acts of fraud are offences. Such offences are referred to in numerous Acts of Parliament (too many to list) in the years 1957 to 2002. In addition, several other Acts, while not using the term "fraud", create offences arising from behaviour of a fraudulent nature.

A specific act of fraud may be a criminal offence, a civil wrong or provide grounds for rescinding a contract. Criminal fraud requires proof of an intentional deception. Civil fraud requires that the victim suffers damage. Bologna and Lindquist (1995) state that fraud in the inducement of a contract may render the contract voidable. Fraud is relevant in the following legal situations, inter



- ❑ civil cases, e.g. tort of deceit, fraudulent misrepresentation,
- ❑ company law offences involving fraud, including fraudulent trading, fraudulent preference, offences involving fraud by officers of a company in liquidation,
- ❑ revenue offences involving fraud,
- ❑ fraud by a debtor in bankruptcy,
- ❑ specific criminal offences involving fraud, e.g. larceny, embezzlement, cheating, damage with intent to defraud, fraudulent conversion, conspiracy to defraud, obtaining credit by fraud, obtaining by false pretences, forgery with intent to defraud, making fraudulent entries in books of accounts, false accounting.

Edelhertz (1995) states that the civil wrong of fraudulent misrepresentation involves the following elements:

- ❑ a false representation or a willful omission made regarding a material fact,
- ❑ the defendant reasonably knew the misrepresentation was false,
- ❑ the defendant intended for the misrepresentation to be acted upon,
- ❑ believing it to be accurate, the victim (plaintiff) took some action or relied on the misrepresentation,
- ❑ the victim was damaged in some way, usually monetarily, as a result of the misrepresentation.

According to Edelhertz (1995), criminal fraud has five principal components, common to virtually every white-collar crime:

- ❑ intent to commit a wrongful act or to achieve a purpose inconsistent with the law or public policy,
- ❑ the disguise of the purpose,
- ❑ offender's reliance on the victim's ignorance or carelessness,
- ❑ victim's voluntary action to assist the offender,
- ❑ concealment of the crime.

A narrower form of criminal fraud is larceny which has the additional elements of:

- ❑ taking another's money or property,
- ❑ taking it against the will, or without the consent, of the owner,
- ❑ with the intention of permanently depriving the owner of the money or property.

For criminal fraud, the criminal act – actus reus – and criminal intent – mens rea – must exist. According to MacGregor and Hobbs ((1998) there are a number of key elements of fraud:

- ❑ dishonesty, whether intentional or non-intentional (i.e. closing one's mind to matters which would have indicated that the conduct was dishonest)'
- ❑ deception,
- ❑ gain, loss and risk.

## **MALAYSIAN LAW RELATING TO FRAUD**

Malaysian law recognizes a large number of criminal offences involving fraud. Several offences

carry different penalties depending on whether the manner of commission of the offence involved any fraud. (the list is not provided as they are too numerous to list down).

## CAUSES AND CATEGORIES OF FRAUD

### Causes of fraud

Fraud can be once-off or systematic. Once-off fraud is likely to be for a large, once-off sum. However, fraud is frequently partially motivated by habit. The perpetrator may need to obtain cash regularly, for example to feed a drug habit or to deal with personal financial pressures.

### Perpetrators of fraud

Moulton (1994) identifies "red flags" to watch for in trying to spot fraudsters. These include large egos, substance abuse problems or gambling addiction, living beyond apparent means, self-absorption, hard working (taking few holidays), under financial pressure from (say) heavy borrowings and sudden mood changes.

Edelhertz (1995) classified white-collar crime by perpetrators into four categories:

1. Ad hoc violations committed by persons for personal gain, operating in a non-business context, e.g. credit purchases (where there is no intention to pay), purchase by mail in another person's name, income tax offences, credit card fraud, bankruptcy fraud, social welfare fraud, insurance fraud.
2. Criminal abuses of trust committed by persons operating inside business, government, a profession or other entity, in violation of their duty of fidelity to employer or client, e.g. commercial bribery and kickbacks, banking abuses by bank officials, employees and directors, embezzlement, share frauds (i.e. insider trading), using company funds to buy shares, petty theft and expense account frauds, computer fraud resulting in unauthorized payments.
3. Business crimes committed incidental to and in furtherance of business operations, but which are not the central purpose of the business, e.g. tax fraud, infringement of competition laws, use of false financial statements to obtain credit, cheque "kiting" to obtain short-term finance, share violations (i.e. manipulation of the market).
4. Fraudulent activities which are the central purpose of the business, e.g. medical or health frauds, share and commodities fraud, chain referral schemes, buying or pyramid schemes.

### Categories of fraud

Fraud takes many forms, has an impact on the public and private sectors of our economy and affects society in many ways. Fraud may be classified in a variety of ways. Some examples of classification of fraud are:

- ❑ Definition - fraud, theft, embezzlement
- ❑ By victim - customers, shareholders, creditors, competitors, bankers, Company/ employer, insurance companies, government agencies
- ❑ Perpetrators of Corporate fraud - owners, managers, suppliers, contractors, customers,

employees

- Frequency - one-off, systematic
- Legally - crime, tort, contractual
- Company - fraud by, for or against companies, internal fraud, external fraud, Transaction fraud, statement fraud
- Type of fraud - concealed fraud, unconcealed fraud

(Source: Adapted from Comer, M.J., Corporate Fraud (3<sup>rd</sup> ed., Gower Publishing Ltd., Aldershot, 1998), Chap. 2.

There is no standardization on the categories or classification of fraud, Different reporting bodies use different categories for types of fraud. Examples of categorizations by three authorities in the United Kingdom are summarized as follows:

#### Serious Fraud Office, U.K.

- fraud on investor
- fraud on creditors of companies
- fraud on banks and other financial institutions
- fraud on central and local government
- fraud involving the manipulation of financial markets

#### Metropolitan Police

- computer
- fraudulent trading
- investment
- "long firm"
- public sector
- mortgage

#### Home Office

- fraud by company director
- false accounting
- other fraud
- forgery

KPMG (1995) in Ireland distinguished between external and internal fraud and classified internal fraud by perpetrator.

Wells (1997) establishes a classification system to explain 44 fraud schemes used by executive owners, managers and employees to defraud companies.

**EFFECTS OF FRAUD**

Fraud has, broadly speaking, two types of consequences. First, there is the cost associated with fraud and, second, there is the effect of the fraud on fraud victims. This section of the article will be elaborated in the forthcoming article – Forensic Accounting (3).

**METHODS OF FRAUD**

This section of the article will also be elaborated in the forthcoming article – Forensic Accounting (3).

**CONCLUSION**

Forensic accountants are notoriously paranoid about fraud. As auditors they have a limitation to their responsibilities for the detection of fraud in companies, although they have had to accept that it is reasonable to expect an auditor to detect fraud that has a material effect on the financial statements. But, situations as they may be, well-organised fraud involving collusion, may well escape detection.

Although Auditing Standards support this position, and in general the courts regard auditors as watchdogs, not bloodhounds, empirical evidence suggests that public expectation is higher. Accordingly, disappointment with the audit process inevitably seems to follow the discovery of fraud.

Forensic accountants can help to bridge this “expectation gap”. One way they can do this is by offering a “fraudit” service separate and distinct from the statutory audit of the financial statements, designed to detect, and perhaps help prevent, fraud by using their forensic and investigative skills and techniques, which are ideally suited to the task.

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