

# PUBLICATION

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## **Avoiding, Investigating and Prosecuting Fraudulent Accounting and the Misappropriation of Corporate Assets**

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**Corporate directors should monitor management's establishment and maintenance of safeguards against fraud.**

The board of directors, particularly the board's audit committee, and management can reduce the exposure of the financial statements to fraud by, among other things, (1) guarding the independence of internal and external auditors from undue influence by management; (2) establishing and maintaining internal accounting controls; and (3) investigating and correcting conditions that permitted the fraud to be carried out. Management's institutionalization of an autonomous internal audit department can ultimately prove to be the critical check when corporate officers are motivated by earnings targets or bonus formulas to manipulate corporate earnings.

According to the Securities and Exchange Commission, large corporate fraud schemes are most often carried out by the upper levels of management. The historic financial statement frauds at Enron and WorldCom were schemes perpetrated or condoned by management at the highest levels. Therefore, strong checks must be in place to stop managerial compromises to internal controls, resulting in fraudulent manipulation of the financial statements or misappropriation of assets.

These compromises can take the form of a corporate culture allowing any individual to use the leverage of their position in the organization to pressure a subordinate to bend the rules. Accounting personnel need to know that they can abide by the accounting rules and that no one, no matter how far above them in the chain of authority, can compel them to override the accounting controls.

**The board and management should expect that a company's independent outside auditors will evaluate the audited entity's exposure to financial statement fraud and will plan and carry out an audit designed to address these risks.**

External auditors are bound by the standards of their profession to assess the risk that fraud will materially affect the financial statements. The independent auditor's audit program should be fashioned to address the risks which are unique to the company under audit. Independent auditors should not just follow last year's audit program. They are obligated by Generally Accepted Auditing Standards (GAAS), as part of every annual audit, to evaluate the client's areas of fraud risk and to design audit procedures to examine that risk. For example, auditors should calculate a series of ratios and examine certain historical financial statement trends to identify areas on balance sheet or income statement which may be at risk for material misstatement due to fraud.

The revenue section of the income statement is vulnerable to manipulation by management. Financial statement auditors are directed by GAAS to "presume there is a risk of material misstatement due to fraud relating to revenue recognition."

Financial statement accounting is largely dependent on estimates. Management can manipulate these estimates and thereby exaggerate the company's net worth and net income. Examples of estimates which can

be distorted by management are the estimate of uncollectable accounts receivable, estimates of expired or unusable inventory, and the estimate of the completeness of a project on which the company is earning income.

**Certified public accountants must maintain objectivity with regard to the audit client and preserve their professional independence of the client.**

Outside auditors are obligated by the standards of their profession to maintain independence and objectivity with regard to their audit client, and particularly with management. This is a challenge for the financial statement auditor because they are hired by management and the auditor serves at the pleasure of management. The natural impulse to "keep" the audit client must, by the direction of GAAS, take a back seat to the auditor's duty to maintain a "mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity."

**To what degree does a financial statement audit provide users of the financial statements assurance that the balance sheet and income statement are free of fraud?**

Financial statement audits are not guaranteed to detect fraud, but the auditor's job is to attain a "reasonable assurance" that the financial statements "are free of material misstatement, whether caused by error or fraud." The fundamental difference between misstatements due to error and those due to fraud is whether the misstatement was intentional.

**The board, audit committee or in-house counsel should initiate an internal investigation of evidence of material misstatement of the company's financial statements.**

An internal investigation led by outside counsel, preferably a lawyer who is a certified public accountant or at least has a strong accounting background, and carried out by a forensic accounting team, can examine the question of whether the financial statement misstatement was due to error or fraud. The forensic accounting team works at the direction of counsel. The forensic accountants are gathering facts which will equip outside counsel to provide legal advice to the board, its audit committee or in-house counsel, as their representative. Therefore, the investigation is conducted under attorney work product confidentiality and the results of that investigation are disclosed to outsiders, such as law enforcement or prosecutors, at the option of the board.

Moreover, the investigation's findings may require a restatement of the audited financial statements. The financial statement auditor will require that the findings of the forensic accounting team be subjected to some degree of testing to assure that the auditor agrees there is a reasonable basis for management's restatement of the financial statements. Outside counsel must be skilled in knowing how to make disclosures to the financial statement auditor from the internal investigation, which are necessary for the auditor to do their job, while preserving confidentiality of the work product from the investigation.

**A forensic accounting investigation may follow or run parallel to the financial statement audit where there is good cause to believe that something is amiss.**

Forensic accountants should be retained to investigate allegations or evidence of fraud. A forensic accounting investigation may be triggered by a tip from an insider, such as a member of the company's accounting department, which is found to be corroborated to some significant degree by evidence. A forensic accounting investigation also may be initiated due to findings by the financial statement auditor. The investigation may be directed toward allegations or evidence of fraudulent accounting or the misappropriation of corporate assets.

Outside counsel and forensic accountants are experienced in conducting an interview of the fraudster in a manner that maximizes the admissions from the fraudster while cutting off the fraudster's ability to explain away or shift responsibility for the fraud.

Unlike financial statement auditors, forensic accountants are not bound to focus on fraud that can have a material effect on the financial statements. The fraud manual published by the Association of Certified Fraud Examiners directs the forensic accountant that, once a fraudster has been identified, the investigation should be expanded to look for other areas that could be impacted by the fraudster, additional schemes, and co-conspirators.

The best way for an organization to discourage fraud is for the organization to investigate allegations of and the discovery of fraud and to act promptly to remove the guilty and, in appropriate cases, pursue criminal prosecution. Outside counsel can work with forensic accountants to accomplish this goal and to organize and present the evidence to prosecutors who are looking at whether the evidence can prove the occurrence of a significant crime by a particular individual "beyond a reasonable doubt."

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