

## Chapter 6

# Relationship between Fraud Auditing and Forensic Accounting

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**Abstract** The duties, responsibilities and expectations of accountants and auditors have become clearer today. A person's knowledge of accounting, auditing, law and modern technology may be required to find solutions to some disputes encountered in both private and business lives. This need arises in the areas that constitute the intersection of law and accounting, especially fraud auditing. This situation has led to the emergence of forensic accountancy / forensic auditorship, which is a separate recognized area of expertise. The aim of this study is to uncover the relationship between forensic accountancy or forensic consultancy or their areas of expertise with fraud and fraud auditing. Stakeholders in need of forensic accountants are also diverse. These may include Lawyers, police and law enforcement agencies, insurance companies, banks, courts, business world, government representatives and government legal entities. The main difference between forensic accounting and classical accounting is that the former investigate and reveal accounting frauds with a systematic approach. Auditing, fraud auditing and forensic accounting are closely related fields. Auditing knowledge and expertise will be useful in fraud auditing and forensic accounting. Similarly, mastering the technical and scientific aspects of accounting will also have a positive effect on fraud auditing. The three main fields of activity of forensic accountancy are fraud auditing or investigative accountancy (administrative support), litigation support (legal support) and expert witnessing (expert testimony). It is possible to benefit from many practices such as techniques applied by the independent auditor in fraud auditing, planning, applied procedures, fraud risk indicators and documentation in forensic accounting studies. In most developed countries, there are organizations providing services in the field of forensic accounting and fraud auditing, and various titles given to them. Comparatively, even in areas not directly related to forensic accounting practice in Turkey, competent authorities to make arrangements in this area. Additionally, there are various regulations regarding forensic accounting profession in the legal system.

**Key words:** Forensic accounting, Fraudulent financial statement, Fraud auditing, Fraud risk factors, Fraud triangle, Internal Auditing& Internal control

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## 6.1 Introduction

Accounting can be defined as recording monetary transactions by using accounts, accounting technique, and summarizing them into financial statements at certain periods or whenever required. Prepared financial statements can be manipulated for many different reasons. The main purpose is mostly to mislead the decision maker expecting the financial information in question due to conflict of interest. The manipulation may be due to error or fraud. The main feature that distinguishes fraud from error is that, it is deliberate and illegal. The main indicator of intent is that it benefits the cheater and is illegal. For example, showing that the business situation is better in order to get access to loans from banks or showing lower profit for a particular period in order to pay less tax.

Finding fraud is more difficult than finding the error because the former involves masking and deliberately hiding something. Today, increasing technology has also affected fraud techniques and has led to the emergence of large-scale cheating. According to the reason for fraud, the main types of fraud can be grouped as: a) employee fraud or abuse of assets, b) financial statement fraud. Revealing employee fraud is one of the main responsibilities of corporate managers, and internal auditors or ombudsmen, if they are public institutions, can be used for this purpose. The task of revealing financial statement fraud is mainly the responsibility of independent auditors. The independent auditor will reveal and correct any inaccuracies, if any, arising from errors or fraud, because of the audit work to be carried out, thus increasing the confidence in the financial statement prepared. Due to the principle of auditor's independence, the accountant who prepares financial statements and the auditor auditing those financial statements should not be the same person. In fact, the principle of independence is a basic ethical principle that should be observed for all kinds of auditing.

The duties, responsibilities, and expectations of accountants and auditors have become clear today. Some events, disputes, legal cases encountered in both private life and business life may require both accounting, auditing and legal knowledge and even technological knowledge to find a solution to the issue. For example, it may be necessary to serve as an expert witness or give an expert report depending on the appointment at the commercial court. This need arises in areas that constitute the intersection of law and accounting, especially fraud auditing, and this has led to the emergence of the profession of forensic accountancy / forensic auditorship, which is a separate recognized area of expertise.

Claims constitute the essence of any audit. The financial statement presented by the management from an independent audit is also a claim. The existence and completeness of the items in the balance sheet and income statement, whether they belong to the company, whether the balance sheet items are valued correctly, whether they are presented properly or not are examined by the auditor both in general and by account items and separately, including the balance sheet footnotes. The claim in employee fraud is to reveal whether the person or persons involved in the fraud-committed corruption. For example, the main task of the accountant or auditor expert appointed by the Commercial Court for a bankruptcy postponement case is to investigate the allegation of insolvency (more debt than assets) of the business management. In

another instance, a newly elected cooperative management may request that the previous management's allegation of corruption be investigated. Or the claim of "assets disproportionate to its income" made against a senior manager in a public or private institution could be the management's desire to have it examined.

In an audit, all kinds of claims are concluded by using special procedures called audit techniques and by gathering reliable and sufficient number of evidence regarding the event or transaction subject to the claim. The main techniques used in all types of audits are interview, observation, counting (physical examination), verification, book and document review and analytical review procedures. However, the main factor that determines where and how these techniques are used is the professional judgment of the auditor thus his expertise and experience.

This study seeks to introduce forensic accounting, its related professions or expertise, which includes the use of the auditor's knowledge in finding fraud audits in various ways in forensic cases, and to uncover their relationship with fraud and fraud auditing.

## **6. 2 Forensic Accounting**

The concept of Forensic Accounting was used for the first time in the study titled titled "Forensic Accounting: Its Place in Today's Economy" published by Maucrice E. Peloubet, who was also a partner of the Peloubet & Comp. Certified Public Accountant Company operating in New York (Al, 2014: 101).

The most widely accepted definition of forensic accounting is as follows:

“It is a science that seeks the truth by using its own research, questioning and analysis techniques, which has been referred to the court or not yet, but the major dimension of the issue that is likely to create a legal conflict is accounting-related disputes, and also uses other branches of science such as psychology and crime science” (Gülten, 2010: 312. Transferring Al, 2014: 103).

Forensic accountancy is a field that mediates law and economy, requires the coordination of investigation, accounting and auditing knowledge and skills, and requires the use of audit methods, techniques and procedures to clarify legal problems. The importance of forensic accounting has increased even more after international financial scandals. With the SOA (Sarbanes Oxley Act) published after the Enron scandal, the Capital Markets Board of America, i.e. The U.S. Securities and Exchange Commission (SEC) stated that forensic accounting practices should be used in audit studies (Karahana, 2020: 158). One of the reasons for the need for the forensic accountancy is its close relationship with other professions and the support services it provides to most of them. Some examples of activities that may be included in the service area of forensic accountants are as follows (Kızıllı et al.2019: 62-63):

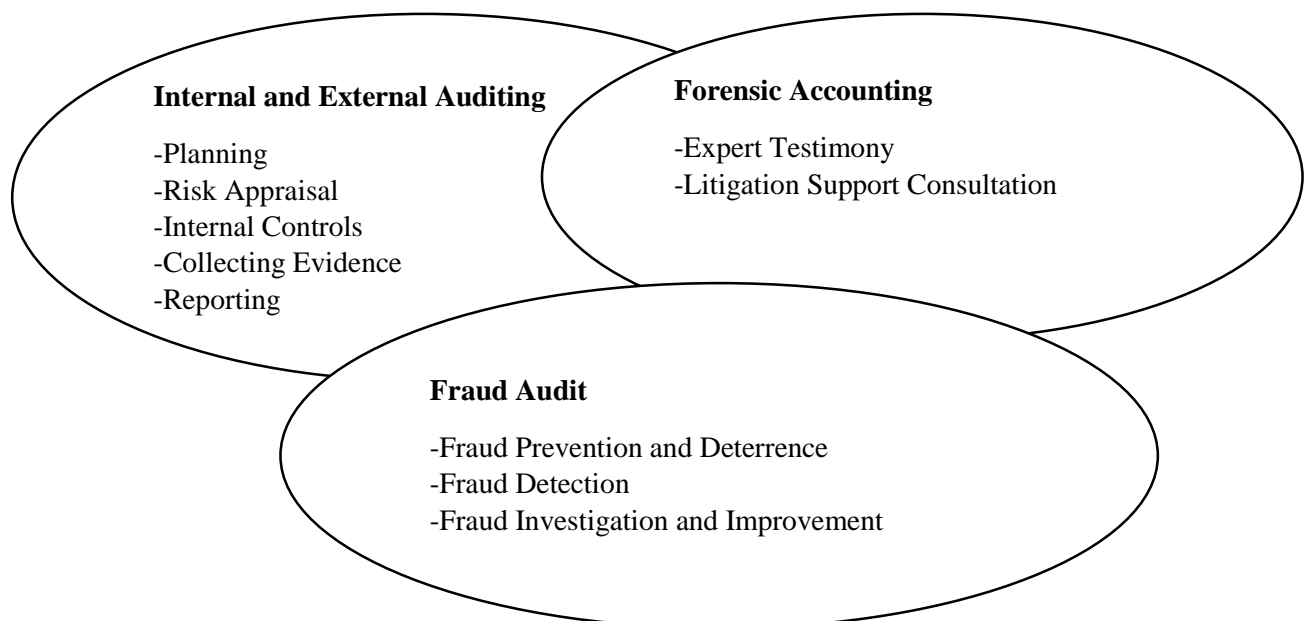
- Legal cases involving fraud and financial corruption, irregularities
- Determination and prevention of employee fraud (embezzlement) crimes
- Partnership and / or shareholder disputes and lawsuits,
- Conciliation / arbitration
- Insurance transactions
- Business negligence

- Physical injury and fatal accidents
- Financial disputes experienced in relation to divorce and marriage.

With the rapid development of technology, the need for forensic accountants who are specialized in the subjects that can reveal frauds made by using computer and online recording, remote connection methods of advanced techniques, who have knowledge of technology, who can evaluate the events in accounting, auditing and legal dimensions have increased (Karahana, 2020: 156). Forensic accounting can also provide administrative, litigation and expert support in the investigations of businesses and various decisions to be taken in financial, managerial, production, sales, marketing and legal areas within the business (Al, 2014: 97). The stakeholders in need of forensic accountants are diverse including but not limited to lawyers, law enforcement, insurance companies, banks, courts (judge, prosecutor), business world, government representatives and government-affiliated legal entities (Kızıl et al., 2019: 63).

Reasons such as the accounting department being in contact with other units, affecting the business completely, requiring a technical expertise and not being able to be controlled by other units make financial reports vulnerable to fraud. Forensic accounting, as a result of commercial activities in time, has emerged with the handling of both the judicial and accounting aspects of the issue. Difference between forensic accounting and classical accounting is that the former investigates and reveal accounting frauds with a systematic approach (Atağan and Kavak, 2017: 200).

Auditing, fraud auditing and forensic accounting are closely related fields as can be seen in Figure 1. Auditing knowledge and expertise will be useful in fraud auditing and forensic accounting. Similarly, mastering the technical and scientific aspects of accounting will also have a positive effect on fraud auditing.



**Figure 6.1:** The Relationship between Audit, Forensic Accounting and Fraud Audit  
Source: (Atağan and Kavak, 2017: 200)

It is stated in the literature that forensic accounting generally consists of three fields of activity. These are (Karahan, 2020: 159):

- Fraud auditor or investigative accountancy (Administrative Support)
- Litigation support (Legal Support)
- Expert testimony (Expert Witness)

When a forensic accountant detects fraudulent or abusive practices, he also calculates the financial losses incurred by the institution or the person, the amount of embezzlement to be charged to the person or persons who committed the act, that is, the material dimension of the event. In general, some of the works that the forensic accountant will do within the scope of litigation support are as follows (Çakır, 2015: 100):

- Providing necessary documents to refuse or support a claim,
- Examining documents to make an initial assessment of the situation and identify missing points,
- Participating in the process of understanding the financial situation and examining the findings that will facilitate the reporting of additional questions to be asked,
- To examine the damage (compensation) claim report submitted by the other party as well as to review the reports about the positive and negative aspects of the current situation,
- To assist negotiations and discussions regarding the settlement (waiver) of the case.

Litigation support is generally applied to cases related to economic losses. For example; such as calculating the profit deprivation of the other party due to unjust termination of the contract between the two parties and being the subject of a lawsuit. It is possible to encounter many different examples regarding fraud control. For example could be embezzlement by a warehouse clerk selling external spare parts at an auto service. Or like an accounting manager in a food company making unfair fortune by fraud.<sup>3</sup>

In the field of expert testimony, for example, the Capital Markets Board (SEC) in the USA and the Serious Fraud Office in the UK can listen to forensic accountants as witnesses (as expert witnesses). The most widely used type of forensic accounting in England is expert testimony (Kızıl et al., 2019: 69). Because of all these, in the literature due to the activities they perform to forensic accountants; the names of "research accountant" or "fraud auditor" can also be given (Al, 2014: 103).

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<sup>3</sup>“One of the biggest corruption in recent years occurred at Dimes Food Trade Inc., a famous fruit juice beverage company. The accounting manager, who had worked in the company for 21 years, was arrested when it was determined that he had embezzled 16 million liras in the last 5 years, his wealth was seized”<https://www.hurriyet.com.tr/gundem/16-milyon-liralik-meyveli-vurgun-40329019>

### **6. 3 Fraud Auditing**

According to the Supreme Court, fraud is a qualified lie. Fraud in the broadest legal sense can be defined as depriving a person or a group of their rights or property through any deliberate deceit. In the context of financial statement audit, fraud is defined as an intentional misstatement in the financial statements (Arens et al., 2017: 298).

According to Association of Certified Fraud Examiners (ACFE), occupational fraud is defined as using the assets and resources of the workplace in a planned and deliberate manner for individual enrichment by misusing or mispending, and classifies it in three categories:

- Misappropriation of Assets
- Getting Unfair Profit-Corruption
- Financial Statement Fraud (Fraudulent Financial Statement)

The subject of fraud in the misuse of assets, also known as employee fraud, is not as important as financial statement fraud. However, irrespective of the amount of theft, the theft of business assets, misuse is often closely related to management because, over time, the volume of minor thefts can easily increase, and the realization and disclosure of such incidents significantly damage a company's reputation.

Notable examples of fraud related to misuse of assets, ie employee fraud (Arens vd., 2017:346):

Kerviel also circumvented inspections and controls by using fraudulent means, causing \$ 7 billion in damage. Commercial transaction losses of Societe General, one of the major French banks, reached extreme levels. Although J. Kerviel had a modest salary of \$ 70,000 and was a stockbroker with low job seniority, he entered high-risk transactions linked to European stock index funds, causing a risk that exceeds the bank's net worth. He knew how to camouflage the aforementioned fraudulent transactions to prevent them from occurring. However, the continuous storage of fraudulent transactions was based on the principle of being very vigilant and constantly repeating fake transactions and then deleting them. For this reason, J.Kerviel never took leave and preferred to work even on holidays. However, in subsequent inquiries, Kerviel admitted that he had committed fraudulent and risky transactions amounting to more than 50 billion euros. The bank, on the other hand, jeopardized its 145-year existence and lost EUR4.9 billion (USD7.4 billion) in the process until it settled the transactions. One of the most important reasons behind this failure was said to be an environment of over-trust in the bank. This overconfidence environment did not create strong deterrence and internal control (Clark and Bennhold, 2010).

B. Madoff similarly caused nearly \$ 21 billion in losses with a fraudulent Ponzi scheme that could be considered one of the biggest investor tricks ever. The amount of these fraudulent transactions was approximately twice the USD11 billion fraud at WorldCom. Madoff admitted

to his crime and was sentenced to 150 years in prison (Clark and Bennhold, 2010; Arens et al., 2017: 302).

Fraudulent financial reporting usually means deliberate manipulation of financial statements by or with management's consent and knowledge. Frauds committed by the management, cause greater losses in businesses and often cannot be compensated. Fraud is considered as a risk that can threaten the continuity of the business, depending on its nature and size.

**Table 6.1:** Percentages of Occurrence of Types of Fraud and Average Losses According to ACFE Reports:

Cheat Types	2012		2014		2016		2018	
	Percent	Loss (\$)	Percent	Loss (\$)	Percent	Loss (\$)	Percent	Loss (\$)
Misuse of Assets	%86,7	120.000	%85,4	130.000	%83,5	125.000	%89	114.000
Corruption	%33,4	250.000	%36,8	200.000	%35,4	200.000	%38	250.000
Fraudulent Financial Reporting	%7,6	1.000.000	%9,0	1.000.000	%9,6	975.000	%10	800.000

**Source:** The table was prepared by the authors using data of (ACFE, 2016) and (ACFE, 2018)

The data in Table 1 shows that the analyzed cases contain fraudulent financial reporting at the lowest rate, but that fraudulent financial reporting causes higher losses on average compared to other types of fraud and that type of fraud causes the most serious damage to the whole economy (Kaya and Uzay, 2018:724). In addition, it is noteworthy that fraudulent financial reporting incidents occurring in businesses have an increasing trend from 2012 to 2018.

Although fraudulent financial reporting is a type of crime that affects the decisions of information users and carries a legal risk, it is seen that people in charge of management in businesses resort to this method, especially when things are not going well. Main target of fraudulent financial reporting is to show the net income of the business and / or the value of its assets more than it actually is.

There are various fraud risk factors underlying the above-mentioned main reasons of fraudulent financial reporting by the management. There are three types of fraud risk factors, namely: incentives / pressures, opportunities and attitudes / rationalizations. This is also called the fraud triangle for short. These factors are an indication of whether there is a suitable environment for cheats to occur. Examples of fundamental fraud risk factors include (Kaya and Uzay, 2018:724):

**Incentives / pressures;** performance-based compensation, unattainable targets, high market expectations, need for borrowing or equity financing, excessive competition, decreases in market share, rapid changes in technology, desire to increase reputation, attitudes of audit firms.

**Opportunities;** such as weak internal control system, lack of corporate governance, complexity of accounting standards, inadequacy of disciplinary sanctions imposed on cheaters, lack of internal audit, absence of an audit committee or its ineffectiveness.

**Attitudes / rationalization;** Disputes between management and independent auditors, allegations of legislative breach or fraud with managers, high stock prices providing excessive interest to management, excessive role of non-financial managers in the selection of accounting policies and determination of important estimates, deficiencies of internal control by the management are not remedied, seen as insufficient wages, low motivation of managers.

#### **6.4 Fraud Risk Factors and Prevention of Fraud**

Although three similar situations are valid for fraudulent financial reporting and misuse of assets in the fraud triangle, the risk factors differ. The factors causing fraudulent financial reporting are grouped under three main groups. These are (Küçük and Uzay 2009: 242): (a) weak institutional structure, (b) strong internal and external pressure and (c) weak internal control structure. Some prominent indicators of the weak institutional structure are:

- Lack of moral principles,
- The spirit of leadership and guidance is not felt in the business,
- No internal rules, policies and procedures have been determined,
- Unnecessarily overestimating some of the goals and / or interests of the business.

In SAS 99, the following recommendations have been made for anti-fraud tools coordinated in an enterprise: a) Establishing a culture of honesty and high ethical standard, b) Establishing anti-fraud controls c) Designing an effective surveillance mechanism.

Frequent changes (turnover) in accounting staff or other deficiencies in the accounting and information management process can create an opportunity for misstatement. Many reporting frauds in financial statements were not detected under the supervision of the ineffective audit committee and financial reporting of the board. Weak internal controls, such as separation of duties, authorization, a good document and recording system, and not enough attention to control procedures such as independent verification, often create opportunities for fraudsters (Arens et al., 2017: 300).

A comprehensive sample list of factors causing the risk of fraud observed in large corporate businesses in practice is given in the table below (Aksoy, 2006:2020-2043):

**Tablo6. 2:** Factors causing the risk of fraud observed in large corporate businesses in practice

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### **A- Fraud Risk Factors Regarding Business Management**

- Status of company owners
- Management's power over the Board of Directors
- CEO or president being the founder of the company
- The entity doesn't have an audit committee
- Very few board members are from outside the company
- The possibility of insider trading
- No shareholders holding significant shares outside the company
- Audit committee meetings less than twice a year
- Relative relations between managers and officers
- Company shares are significantly owned by individuals within the company or by less experienced managers who provide management services to other companies
- Extraordinary movement of company shares in the Stock Exchange
- Company's first CEO still in office

### **B- Fraud Risk Factors Related to Internal Control**

- Relationship of Internal Auditors with Managers
- The existence of processes and controls that are not taken care of enough that may cause incomplete reporting
- Professional experience of internal auditors
- Senior management's report on internal control

### **C- Management's Characteristics and Effects on the Control Environment**

- Management's tendency to take excessive risks
- Inexperienced management
- Conflict of interest within the company or among staff
- An exchange of ideas with the client company
- Management's reputation in the business environment is poor
- Significant business commitments
- Illegal behavior of the customer company personnel
- Top management's view and course of action on the audit team
- Lifestyle (luxury assets, luxury living conditions, etc.) not suitable for the management's status
- Insufficiently controlled anti-centralist organizational structure
- Management's dishonesty

### **D- Fraud Risk Factors Related to Financial Performance**

- Checking cash bank reserves for compliance with sales
- Asset composition (high stock quantity / total assets; high amount of receivables / total assets; high total current assets / assets;
- Financial ratio analysis

- Low investment turnover

#### **E- Risk Factors Related to the Operating Characteristics and Financial Status of the Business**

- Organizational structure is very complex
- Assets, liabilities, expenses or revenues are based on significant estimates, and these estimates contain extraordinary biases and uncertainties.
- The records are kept out of the ordinary, or the related assets or items are not audited, or another company has been audited
- Inability of the business to generate cash flow from its activities, despite the increase in earnings
- Unusually fast growth or profitability compared to its peers
- The business is very sensitive to changes in interest rates
- Existence of significant pressure to supplement capital in order to remain competitive
- Existence of the close posting threat
- The existence of a motivation tool that may cause the business owner / manager to make irregularities in financial reports.
- The entity is unusually dependent on borrowing or has difficulty amortizing debt repayments
- Possibility of the recovery of poor financial results to have an adverse effect on key issues of the business, such as borrowing from the bank.
- Tight relationships between the business owner or managers and the current auditor or previous auditor
- If the financial situation of the business is weak or bad, the company directors or owners who have personally been a guarantor for the important debts of the company.

#### **F- Risk Factors Related to the Conditions of the Industry in which the Business Operates**

- Increase in business failures and significant decrease in customer demand
- New calculations or regulatory requests that may disrupt the financial condition or profitability of the business
- Sudden changes in the industry in which the business operates

#### **G- Evaluation Phase of Fraud Risk Factors Regarding the Client Firm**

- At the stage of acceptance (continuation) of the customer
- In the audit planning process
- During the examination of the previous period financial statements and audit reports
- In all processes until reaching the audit opinion

#### **H- Methods Applied to Determine Fraud Risk Factors While Deciding to Continue Customer Acceptance**

- Checklist where risk factors are flagged
- 5-of-a-draw showing the risk level, with 1 being the lowest and 5 being the highest

#### **I- Valuation Methods Used by Those Who Make the Valuation of Fraud Risk Factors in the Audit Planning Stage**

- Marking the factors as yes / none by listing them with their examples
- sorting the factors and evaluating them as low / medium / high

#### **J- Those Who Carry Out the Assessment of Fraud Risk Factors**

- Lead Auditor
- Joint auditor
- Assistant auditor
- Responsible chief auditor
- Responsible joint lead auditor

#### **K- Practices for Fraud Risk Assessment**

- Risk Assessors
- Those Who Do Not Make Risk Assessment
- Those Who Prepare a Separate Program Outside the Normal Audit Activities

**Source:** (Aksoy, 2006:2020-2043)

Fraud is often discovered by management, internal audit, or by accident. Independent auditors will find a relatively small portion of fraud, but they are more likely to find fraud that will have significant impact on the financial statements (Arens et al., 2017: 319). Business management is the main responsible for the management of fraud risk in businesses, and the activities that can be taken from the business management in response to fraud prevention, detection and fraud can be summarized as follows:

##### *a) Preventing fraud:*

- Fraud risk assessment
- Anti-cheat controls to processes
- In-house communication and training
- Employee and 3rd party evaluations
- Code of conduct (ethical codes)

##### *b) Revealing the fraud:*

- Help and notice line
- Supervision and monitoring
- Proactive data analysis

##### *c) Responding to fraud (reaction):*

- Investigation protocols
- Notification protocols
- Improvement actions and protocols

Internal audit plays a vital role in oversight activities to ensure that anti-fraud programs and controls are operating effectively. Internal audit activities both prevent and detect fraud. Therefore, internal audit is one of the most important complementary and supportive components of fraud examining. Internal auditors help prevent fraud by reviewing and assessing internal controls that reduce the risk of fraud. They also help in detecting fraud by

implementing audit procedures that reveal fraudulent financial reporting and misuse of assets. (Arens et al., 2017: 309).

Some regulations, principles and rules introduced by regulatory institutions for the detection and prevention of fraud are also beneficial. Major examples of such arrangements are:

#### ***6.4.1 Reporting the Effectiveness of Internal Controls on Financial Reporting***

Problems observed in financial reporting in businesses such as Enron, Worldcom, Parmalat among others have revealed serious deficiencies and flaws in internal control. In order to address these concerns, the United States public company administrations; reporting and evaluating the effectiveness of their internal controls on financial reporting (Aksoy, 2005:45-79) use article 404 of the Sarbanes-Oxley Act (SOX).

However, auditor reports on internal control effectiveness are also required for larger public companies. Similar legal regulations have started to be issued in different countries. "J-SOX", which makes management and supervisory reporting on internal control mandatory for companies in Japan, is one of them.

Section 404 (a) of the SOX requires that the internal control report that public business managements must issue include:

- A statement that business management is responsible for establishing and maintaining adequate internal control system, structures and processes for reporting of financial statements.
- Evaluation of the effectiveness of the business's internal control system, structure and processes for financial reporting as of the end of the financial year.

Business management should also define the framework used to assess the effectiveness of internal control of a business. Most US companies use the internal control framework of the Treadway Commission Supporting Organizations Committee (COSO), which was published in 1992 and updated in 2013. Apart from this, there are different frameworks in the world such as the Risk Management Guide of the UK Financial Reporting Council, Internal Control and Related Financial and Business Reporting or Canada's Control Assessment Guide (CoCo). The discovery of the existence of fraud also affects the auditing report on internal controls and internal control system over financial reporting for listed companies. According to the Public Company Accounting Oversight Board (PCAOB) audit standards; the presence of fraud of any size, involving the senior management, significantly affects the auditor's opinion on internal controls over financial statements and all financial reporting processes (Arens et al., 2017: 322-337).

#### ***6.4.2 Active Oversight of the Audit Committee***

The audit committee is expected to play a proactive role in the management's assessment of fraud risk and monitoring the processes to respond to these risks. The audit committee also reinforces management's zero tolerance for fraud, helping to form an effective senior management on the importance of honesty and ethical behavior (Arens et al., 2017: 310).

### **6.4.3 Corporate Governance Principles**

Corporate governance also minimizes the risk of fraud with the corporate culture created by applying the principles of fairness, transparency, accountability and responsibility in an institution, and is also important in terms of preventing family conflicts in companies, bringing qualified people to the organization and continuity of the institution.

### **6.4.4 Notice Bonus**

By establishing a legal infrastructure in the USA, incentive bonuses are paid to successful notifications, especially for public companies, through whistleblowing. In this context, SEC paid approximately \$ 50 million in 2015 (Arens et al., 2017: 305). Payment in lieu of Notice (Notice bonus) is made for tax purposes in Turkey, evaluated with regard to the applicability of the area in terms of Capital Markets Board of Turkey (CMB) and Turkish Banking Regulation and Supervision Agency (BRSA)<sup>4</sup>.

## **6.5 Fraudulent Financial Reporting and Independent Auditor's Responsibility**

In the event of a suitable and favorable environment for fraudulent financial reporting, the business management uses a number of fraud techniques to show the current situation of the business better or worse than it actually is. The ways in which fraudulent financial reporting can be made by the business management are specified in ISA 240, A3, and examples that are more specific are summarized in Table 2.

**Table 6.3:** Fraud Techniques in Financial Statements

<b>Purpose of Fraud</b>	<b>Fraud Technique</b>
To show the financial condition of the business better than it actually is.	<ul style="list-style-type: none"> <li>- Premature recording of revenue</li> <li>- Unrealized revenue recording</li> <li>- Raising assets or reducing debts</li> <li>- Reclassification of long or short term assets to correct liquidity status</li> <li>- Classification of short term debt as long term debt</li> <li>- Selling a low valued asset at a higher value</li> <li>- Providing discount income by paying debts unnecessarily early</li> <li>- Transferring current period expenses to the next period</li> <li>- Avoiding disclosure of an unexpected event that would adversely affect the company.</li> </ul>

<sup>4</sup> BRSA carries out the functions of regulation, supervision and enforcement within the aim of providing reliability and stability in financial markets, ensuring the efficient running of credit system, protecting rights and interests of savers and developing financial sector considers strategic planning as one of the main instruments to fulfill its duties effectively (BRSA, 2020).

Showing the financial condition of the business worse than it actually is.	<ul style="list-style-type: none"> <li>- Transferring current period income to next periods</li> <li>- Recording future period expenses as expense for the current period</li> <li>- Storage of turnover</li> <li>- Increasing expenses in an unrealistic way</li> <li>- Excessive depreciation and provisioning.</li> </ul>
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**Source:** Table content prepared by authors.

As stated in Table 2, fraudulent financial reporting occurs in many different ways in businesses. Since financial statements provide a summary of accounting records, it is inevitable that frauds will also be of accounting origin. Auditors risk frauds evaluate for disclosures and presentations, both generally at the financial statement level and at the level of claims for transaction groups, account items. The auditor's assessment of fraud risk should continue throughout the audit.

While analytical review procedures are useful in detecting fraud, paying attention to fraud risk factors known as "red flags" may be useful, but standard audit procedures may not be sufficient to detect and prevent fraud. For this reason, using effective statistical methods such as data mining and using artificial intelligence by taking advantage of today's increasing technology will increase efficiency. The main audit methods used by the auditor in suspected fraud are: interview, listening, observing behavioral clues, audit software analysis, extended supportive tests, and other audit inferences (Arens et al., 2017: 319).

### ***6.5.1 Specific Risk Areas of Fraud***

Revenue, credit, and cash accounts are particularly susceptible to manipulation and fraud. A study supported by COSO found that more than half of the financial statement frauds were related to income and accounts receivable. Although fraudulent financial reporting incidents related to trade receivables are less frequently encountered than frauds involving stock or accounts receivable, they show relatively common characteristics. The most common area of fraud in income (earnings) transactions; It relates to perpetrators of cash payments to fictitious accounts and payments to fictitious suppliers. Examples of other fraud risk areas; fixed assets, intangible assets, and fee expenses are more sensitive than others, but there is manipulation for almost every account item (Arens et al., 2017: 313-318).

### ***6.5.2 Assessing the Risk of Fraud***

In evaluating the risk of fraud, the auditor should have a questioning mind-set. Inquisitive thinking or professional scepticism; It emphasizes that the client's sensitivity to fraud should be taken into account, regardless of the auditor's beliefs and management's integrity and integrity regarding the possibility of fraud. An Auditor in the critical assessing of audit evidence, should be careful not assume that the misstatement is an exceptional event or try rationalizing it. The auditor's sources of information to assess fraud risks are as follows (Arens et al., 2017: 303-304):

- Meetings between the Audit Team

- Discussions with Management
- Risk factors
- Analytical Procedures
- Other Information (Auditors take into account any information they obtain at any stage of the audit while assessing the risk of fraud).

According to ISA 240, the responsibilities of the independent auditor regarding fraud are summarized as follows:

*Risk Assessment Procedures:*

The auditor applies the following audit procedures to obtain information that will be used in identifying risks of material misstatement due to fraud:

- Discussions with management (for example; management's evaluations on fraudulent financial reporting, the process followed by management against fraudulent financial reporting, management's communication with senior management on fraudulent financial reporting, if any, management's communication with senior management on business practices and ethics)
- Understanding what kind of oversight management performs over internal controls,
- Questioning the unusual relationships it determines, especially with analytical examination procedures,
- It is the question of whether the information obtained in other studies is a risk factor for fraud.

The Legal Responsibility of the Auditor in the Detection of Fraud, in summary:

- The auditor must provide reasonable assurance that the financial statements are free from material misstatement, regardless of their source.
- Therefore, it has to carry out its studies with professional scepticism during the audit.

In order for the independent audit to be valid, the auditor must comply with the independent audit standards. In case there are situations that are against the independent audit standards and whose contradiction cannot be remedied or eliminate independence, an independent audit is deemed not to have been performed at all.

- In the event that a clear fault of the independent auditor is detected in the derogation of the independent audit, the relevant responsible partner lead auditor and the independent audit firm are jointly responsible for other damages, including the announcement costs.
- In the event that the independent audit report regarding the independent audit deemed invalid was previously announced together with the financial statements, the fact that the independent audit was deemed invalid is announced again in accordance with the same procedures and principles together with the relevant financial statements.

- In addition, criminal liability for those who prepare and arrange an independent audit report contrary to the independent audit standards are subject to special provisions specified in the Law.

As a result, if we summarize the above explanations; In particular, it is possible to benefit from many applications such as techniques, planning, procedures, fraud risk indicators, fraud detection and certification, which the independent auditor applies in fraud auditing, in forensic accounting studies.

## **6.6 Fraud Auditing and Forensic Accounting Applications**

In the USA, audit firms (CPA firms) also perform jobs such as accounting and tax services, management and risk consultancy, as well as audit and assurance services. Audit firms are constantly developing new products and services, such as; such as financial planning, business valuation, forensic accounting and information technology consultancy (Arens et.al, 2017: 25). The main organizations serving in the field of forensic accounting and fraud auditing are as follows (Kızıl et al., 2019: 69):

- Association of Certified Fraud Examiners (ACFE)
- Institute for Internal Controls (IIC)
- The Canadian Institute of Chartered Accountants (CICA)
- The Chartered Accountants (CA)
- National Association of Certified Fraud Examiners (NACFE)
- National Association of forensic Accounting (NAFA)
- The Institute of Certified Forensic Accountants (ICFA)
- International Institute of Certified Forensic Accountants (IICFA)
- Network of Independent Forensic Accountants (NIFA)
- Association of Certified Forensic Investigators of Canada (ACFI)
- American Board of Forensic Accounting (ABFA)
- International Institute of Certified Forensic Investigation Professionals (IICFIP)

The main titles used as a forensic accountant in the USA, where the profession is most developed, and given by different institutions: FCPA (Forensic Certified Public Accountant), FA (Forensic Accountant), Cr. FA (Certified in Forensic Accountant), CFF (Certified Financial Forensics), ABV (Accredited in business Valuation), CFE (Certified Financial Forensics). (Kurt and Uçma, 2009: 170).

In Turkey, International Fraud Examiners Association (USIUD) is an association established and registered entirely in accordance with Turkish legislation. In addition, USIUD is also the representative of the Association of Certified Fraud Examiners (ACFE), which is headquartered in USA. The mission of USIUD (ACFE Turkey) is to lobby and publicity initiatives for the acceptance of fraud investigation expertise as a profession, to provide support through training activities to professionals who want to perform the profession or are still doing it, together with the establishment of the necessary legal order, professional standards and ethical rules. While

fulfilling this mission, USIUD contributes directly or indirectly to those who perform the profession, those who will choose this profession, to private sector and public institutions exposed to corruption, to the country and society. The association also provides Certified Fraud Examiner-CFE certification, which is valid all over the world to professionals who will complete the required requirements and exams (USIUD, 2020).

In Turkey, forensic accountancy does not have a direct application. However, the following are examples of organizations authorized to regulate activities within the scope of forensic accounting (Kurt and Uçma, 2009: 167):

- Operating under the Ministry of Treasury and Finance; Financial Crimes Investigation Board, Tax Inspection Board, Revenue Administration, Treasury Controllers Board
- Banking Regulation and Supervision Agency (BRSA)
- Capital Markets Board (CMB)
- Certified Public Accountant and Turkey Union of Chambers of Certified Public Accountants (TURMOB)
- Public Oversight, Accounting and Auditing Standards Authority (KGK)

Undergraduate and postgraduate education programs are found in countries such as the USA and Canada where forensic accounting is more developed. For example, Utica College in New York, Economic Crime Management-ECM program. In Canada, HEC Montréal is a French-language university institution offering internationally renowned management education and research. HEC Montreal in collaboration with the University of Toronto, such as the program named "Investigator and Forensic Accounting" (Kızıl et al., 2019: 69).

In Turkey, according to the survey by (Kıllı, 2016), as of 2016, there was no undergraduate or graduate program named "Forensic Accounting", in the business program; It has been determined that 1 undergraduate, 6 master's and 6 doctoral programs have elective courses under the headings of "Forensic Accounting" or "Forensic Accounting and Fraud Control". In addition, from 2004 a total of 18 master's theses and 6 doctoral dissertations have been prepared in the field of forensic accounting.

Forensic accounting can be considered as an area of expertise for professional accountants in Turkey. In fact, it can also be considered as an area of expertise for the profession of lawyer with expertise in other areas to which they relate. As a matter of fact (Karahana, 2020), 65% of the lawyers surveyed agree with the view that "judicial accounting is needed to prevent fraud and corruption." In order to raise awareness about forensic accounting, auditing courses can be added to the education programs of law faculties in addition to accounting courses. "Business Law" or "Business- Law Interdisciplinary Graduate Programs" can be opened.<sup>5</sup>

In fact, the Istanbul Chamber of Financial Advisors has organized "Independent Forensic Accounting Expertise Training" for professionals since 2009. In addition, the "expert opinion"

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<sup>5</sup>In Turkey, there is a master's program (with thesis/non-thesis) named "Economic Law" run by the Institute of Social Sciences, Bilgi University. However, the purpose and content of this program differs from the "Business Law" that we propose to open.

part of the 293th Article of the Law on Civil Procedure No. 6100 was regulated in 2011 (Al, 2014: 102).

In addition, the private auditor brought by the Turkish Commercial Code No. 6100 was provisioned to protect the right of shareholders to obtain information about companies. Also, every shareholder may request the general assembly to clarify certain events with a special audit, even if it is not included in the agenda, if necessary and if the right to obtain information or review has been exercised before. The law underlined that it cannot be applied for special audit in every issue and in the justification of the article on the specific issue. It has been stated that there may be any business, transaction, decision, the need for financial resources, company losses, decisions of controlling shareholder company (article 438/1). While the independent auditor is elected by the general assembly of the company, the duty to appoint the special auditor is left to the independent courts.

However, the law did not allow the shareholders or minority right holders to apply to the court directly without requesting from the general assembly, and made a request to the general assembly in this regard as a prerequisite. The subject of private auditing also overlaps with the forensic accounting profession.

#### **6.4 Conclusion**

In Turkey, forensic accounting has become an area of interest for researchers and there is an accumulation of articles and theses on it. In addition, it is observed that, it has become part of undergraduate and graduate education programs as a "course".

However, since the profession does not have any legal status, forensic accounting works are carried out by persons with titles such as accountants, independent auditors, experts, conciliators, mediators, trustees, concordat commissioners and lecturers who give opinions to the court. Turkey should create a model of Forensic accounting by examining closely the models of countries such as USA, the UK and Canada where forensic accounting is well established. A competent position should be defined and legal principles (such as introduction to the profession - training, internship and examination conditions - duty areas, powers and responsibilities, professional ethical principles and the like) should be published.

However, in any case, the person who will do the profession should have the title of "independent auditor" from the KGK. Because the common point of many different task areas of forensic accounting is based on the examination of the claims by using audit techniques and the preparation of reports as a result, and it shares many similar practices with fraud auditing for fraudulent financial reporting.

After the necessary legal infrastructure of the profession is established, the opening of undergraduate or graduate level specialization programs for the said education will already happen automatically.

Turkey, by preparing the legal infrastructure of the then independent of the audit profession in 1989 had already facilitated the transition to forensic accountancy to a considerable extent. The

next step should be to achieve a global professional organization similar to the international professional organization of the internal audit profession.

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