Recent corporate accounting scandals and the resultant outcry for transparency and honesty in reporting have given rise to two disparate yet logical outcomes. First, forensic accounting skills have become crucial in untangling the complicated accounting maneuvers that have obfuscated financial statements. Second, public demand for change and subsequent regulatory action has transformed corporate governance. Increasingly, company officers and directors are under ethical and legal scrutiny. Both trends have the common goal of responsibly addressing investors' concerns about the financial reporting system.

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 statements. Forensic accounting skills are becoming increasingly relied upon within a corporate reporting system that emphasizes its accountability and responsibility to stakeholders.

**Poor Corporate Governance and Accounting Failures**

The scandals of the last few years came as a shock not just because of the enormity of failures like Enron and WorldCom, but because of the discovery that questionable accounting practice was far more insidious and widespread than previously envisioned. A definite link between these accounting failures and poor corporate governance is beginning to emerge. Adelphia, for example, was given a very low 24% rating by Institutional Shareholder Services on its corporate governance score. In Europe, Parmalat and Royal Ahold ranked in the bottom quartile of companies in the index provided by GovernanceMetrics International. The Corporate Library had issued early failure warnings on WorldCom and Enron. An increasing number of researchers are finding that poor corporate governance is a leading factor in poor performance, manipulated financial reports, and unhappy stakeholders. Corporations and regulatory bodies are now trying to analyze and correct any existing defects in their reporting system.

**Problems Within the Corporate Reporting System**

The interests of investors and other stakeholders are usually protected by a three-tier security system. At the top level is the com-
pany’s governance code, which is directed toward enforcing company policies, achieving company objectives, monitoring company performance, and ensuring adequate disclosure of the company’s activities. At the other end is the reporting system regulated by public and private institutions such as the SEC, the PCAOB, and FASB, which subject public companies to accounting and disclosure standards, and their auditors to audit, independence, ethical, and quality control standards. Linking the two extremes is a company’s system of internal control, which provides reasonable assurance on the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable laws and regulations.

This system, however, seems to have been inadequate in many companies. As corporations scramble to realign their interests with those of their stakeholders, three main areas of weaknesses are emerging:

**Lack of a well-developed and implemented policy of corporate governance.** The primary goal of corporate governance is to enhance the value of a company through ethical behavior, espousing a policy of openness and fairness and ensuring informed decision making throughout the company. Unfortunately, the center of corporate ethics—the board of directors—in certain cases became a magnet for unethical practices. Blinded by the glare of a rapidly growing stock market, pressured by stockholders for ever-increasing returns, and led by executives seeking to maximize bonuses based on stock performance, certain boards of directors and audit committees failed to constrain “creative” accounting to keep up their earnings numbers. It must have seemed to some directors that the investing public really did not care about issues such as executive compensation, as long as they made their double-digit returns. The ratio of executive pay to that of the average worker ballooned to 600 to 1 in 2000, from 100 to 1 in 1990. Closed, entrenched boards magnified the problem as directors rewarded themselves for “quality” performance until, finally, the bubble burst.

**Lack of honesty and transparency in reporting.** The financial reporting standards in the United States are the most highly specified in the world. But falling stock markets, corporate failures, dubious accounting practices, abuses of corporate power, and criminal investigations indicate that the system is under stress. Some corporations have grown dramatically through acquisitions funded by inflated stock prices and promises of an even brighter future. In others, it seems as if the checks and balances that should protect shareholder interests were pushed to the side, driven by pursuit of the bottom line.

It has traditionally been an auditor’s responsibility to express an opinion on whether financial statements are presented according to GAAP. Contrary to the expectations of many in the public, the auditor does not have an absolute duty to uncover fraud, although SAS 99 prescribes steps for auditors to take in order to ensure that they have planned and implemented their audits in a way that responsibly addresses fraud considerations.

**An ineffective and inefficient system of internal control.** A good system of internal control will usually help a company achieve its objectives of profitability and minimize loss of resources. Internal control cannot, however, change an inherently weak management system or provide absolute assurance as to the reliability of financial reporting.

Companies are now facing increasing levels of legal, regulatory, and economic reporting requirements, because of the Sarbanes-Oxley Act of 2002 (SOA). Companies are spending millions of dollars examining their existing systems, and adopting or improving their governance and internal controls to meet the standards set by SOA sections 403 and 404.

In today’s rapidly changing business landscape, it is now necessary for accountants and companies to step away from the traditional approach that emphasized compliance with GAAP, and to focus on the study and investigation of the traits underlying corporate behavior and management. This could be the key to preventing future meltdowns, and to guaranteeing the two important qualities of corporate reporting: transparency and honesty.

**The Connecting Link**

Initially, forensic accountants were used by government agencies, such as the CIA, the FBI, and the IRS, to uncover and investigate fraud. They became financial detectives, independent experts employed by management to uncover fraudulent financial reporting and misappropriated assets. In the current reporting environment, forensic accountants are in great demand for their accounting, auditing, legal, and investigative skills. They can play a greater role in coordinating company efforts to achieve a cohesive policy of ethical behavior within an organization.

The definition of forensic accounting is changing in response to the growing needs of corporations. Bologna and Lindquist (in *Fraud Auditing and Forensic Accounting*, 1995) defined forensic accounting as "the application of financial skills, and an investigative mentality to unresolved issues, conducted within the context of rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of the legal system.” This implies that the forensic accountant should be skilled not only in financial accounting, but also in internal control systems, the law, other institutional requirements, investigatory proficiency, and interpersonal skills. Corporations can rely on these skills for developing a consistent system of corporate governance, disseminating such information within and out-
side the company, ensuring that governance policies and objectives are interwoven into the internal control system, setting up fraud prevention systems, and investigating any existing fraud.

Core Knowledge

A forensic accountant is expected to be a specialist in accounting and financial systems. Yet as companies continue to grow in size and complexity, uncovering fraud requires a forensic accountant to become proficient in an ever-increasing number of professional skills and competencies. Here are some of the broad areas of useful expertise for a forensic accountant:

- An in-depth knowledge of financial statements, and the ability to critically analyze them. These skills help forensic accountants uncover abnormal patterns in accounting information and recognize their source.
- A thorough understanding of fraud schemes, including but not limited to asset misappropriations, money laundering, bribery, and corruption.
- The ability to comprehend the internal control systems of corporations, and to set up a control system that assesses risks, achieves management objectives, informs employees of their control responsibilities, and monitors the quality of the program so that corrections and changes can be made.
- Proficiency in computers and knowledge of network systems. These skills help forensic accountants conduct investigations in this era of e-banking and computerized accounting systems.
- Knowledge of psychology, in order to understand the impulses behind criminal behavior and to set up fraud prevention programs that motivate and encourage employees.
- Interpersonal and communication skills, which aid in disseminating information about the company's ethical policies and help forensic accountants conduct interviews and obtain crucially needed information.
- Thorough knowledge of a company's governance policies and the laws that regulate these policies.
- Command of criminal and civil law, as well as of the legal system and court procedures.

With this background, the forensic accountant is distinctively positioned to explore the design of corporate governance systems, the role of the financial reporting system in corporate governance, the effect of the governance board on employee and managerial behavior, and the efficacy of the internal control system.

A Broad Role

Companies need a centralized program and an established system to measure and monitor internal controls' effectiveness and the alignment between corporate governance, internal control, and external reporting activities. Many are setting up governance officers or governance committees to meet the demand for corporate integrity. The governance committee must be active in every area of corporate activity to ensure that the company is operating as a synergistic whole. As part of the governance committee, a forensic accountant can make a significant contribution in each of the following areas:

Corporate Governance. With a strong background knowledge of the legal and institutional requirements of corporate governance, a forensic accountant can help formulate and establish a comprehensive government policy that ensures an appropriate mix of management and independent directors on the board; sets out the appropriate responsibilities of the board and the audit committees; has a fair allocation of power between owners, management, and the board; and ensures there is a company code of ethics for employees and management. Ethical behavior is reinforced when top management shows, through its own actions, that questionable behavior will not be tolerated.

Preventing fraud. Forensic accountants understand that the best way to prevent fraud is to establish an efficient control system that encompasses: a good control environment determined by management's philosophy of ethical behavior and strong corporate governance policies; a superior accounting system that ensures the proper recording, classification, and reporting of all relevant transactions; and strong procedural controls that provide for safeguarding of assets, proper authorizations, audit mechanisms, and proper documentation.

Creating a positive work environment. A good fraud prevention program also accompanies a positive work environment where highly motivated employees are not tempted to abuse their responsibilities. Forensic accountants can ensure that governance policies are formulated to avoid high-risk environments where management is apathetic, pay is inadequate or too high, there is a serious lack of proper training and compliance, or there are unreasonable profit and budget goals. It is also necessary to have well-defined hiring policies that result in honest, well-qualified employees.

Establishing effective lines of communication. Communication is a key element in ensuring that employees and other stakeholders are aware of their rights and responsibilities. Effective communication (as defined by Committee of Sponsoring Organizations of the Treadway Commission, COSO) must flow not just from the top to lower levels, but also across employee lines of responsibility. Forensic accountants can support the dissemination of the required information about governance and ethics policies to interested parties within and outside the organization. Adequate reporting is also necessary to meet the compliance requirements of the SEC and the stock markets.

Vigilant oversight. Any system needs to be constantly monitored and evaluated to make sure that it is functioning well. A forensic accountant can monitor not only compliance at the top levels of corporate power, but also management procedures and employee activity. Information gathered as a result of the monitoring can be used to readjust and reformulate governance, ethics, and control policies.

Establishing consequences. Fraud deterrence should also include an expectation of punishment. The forensic accountant can help in creating policies that clearly state the company's intent to take action against any criminal activities, and that such action will apply to all levels of employee.

Fraud investigations. A forensic accountant can ensure the integrity of financial statements by actively investigating for fraud, identifying areas of risk and associated fraud symptoms, pursuing each anomaly aggressively, and delving into the minutest details of accounting and financial anomalies.

By helping companies prevent and detect fraud, the forensic accountant's role can easily evolve into a key component in the corporate governance system.

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