FORENSIC ANALYSIS: A MODERN APPROACH TO IDENTIFYING FRAUDULENT BEHAVIOR

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It probably won't surprise our readers that when corporate executives commit crimes, they rarely turn themselves in. In fact, they go to great lengths to mask their miscreant behavior. In most cases they are able to obfuscate the behavior because (1) they are smart and (2) they have accomplices who share their desire to maintain an appearance of honesty.

However, crimes and crime scenes are never as clean as they may first appear. By applying forensic identification – "the application of science and technology to identify objects from the traces they leave" – a forensic analyst can uncover important evidence beyond the smoking gun without waiting for a confession.

As in a typical criminal investigation, one looks for circumstantial evidence (such as low Expense recognition); direct evidence (such as the back-dating of Options); and motivation.

In the corporate world, motivation is not difficult to identify. Large financial incentives to step over the line are always present. The more difficult issue is finding traces of evidence that point to the crime.

Audit Integrity investigations compare the corporation's accounting and governance practices to patterns of behavior of known frauds. We have collected data on over 1,000 fraudulent corporations and modeled the behavior (traces) of each of these companies. Regardless of the specific fraud committed by these corporations, key elements of their behavior can be extrapolated and used as indicators of fraudulent actions which have not yet been exposed.

These traces are categorized into three classes of fraud detection.

- **Earnings Quality** models look at accrual issues
- **Forensic Accounting** focuses on the transparency of financial reporting
- **Corporate Governance** measures look at management behavior and motivation

Audit Integrity examines numerous metrics associated with these three classes. Each of the metrics represents a trace of fraud. It is interesting to note that one or two fraud traces are not sufficient to indict a company. In fact, ***most fraudulent companies leave in excess of ten traces in any one reporting period***, and often the behavior persists beyond a single period. Multiple traces over extended time periods reflect a pattern of behavior that is fraudulent in nature; when a cluster of these factors occurs, the revelation of malfeasance is highly probable. Below are examples of the timely predictiveness of Audit Integrity analysis:

Company Name	Fraud Amount	Fraud Period				AGR		
		Begin		End		Avg. Fraud	Average	# of
		Year	Qtr	Year	Qtr	Period AGR	AGR Rating	Very Aggr
Waste Management Inc.	1,700,000,000	1992	1	1999	4	44	Aggressive	**12**
Sunbeam Corporation	391,000,000	1996	1	1998	2	39	**Very Aggressive**	**6**
Cendant Corporation	600,000,000	1997	2	1998	2	26	**Very Aggressive**	**2**
Rite Aid Corporation	275,800,000	1997	1	2000	1	71	Average	0
Xerox Corporation	3,100,000,000	1997	1	2000	4	44	Aggressive	**8**
Tyco International	1,562,000,000	1998	4	1999	4	21	**Very Aggressive**	**5**
Adelphia Communications	2,300,000,000	1999	3	2002	2	60	Average	**1**
Citigroup	625,000,000	1999	3	2002	3	17	**Very Aggressive**	**13**
Computer Associates International, Inc.	4,700,000,000	1999	2	2002	1	43	**Very Aggressive**	**9**
JDS Uniphase Corporation	44,000,000,000	1999	3	2001	3	27	**Very Aggressive**	**8**
WorldCom Inc. - MCI Group	11,000,000,000	1999	2	2002	2	75	Average	0
American International Group, Inc.	500,000,000	2000	4	2002	1	51	Aggressive	**7**
Enron Broadband Services, Inc.	1,561,000,000	2000	4	2001	1	42	**Very Aggressive**	**1**
Lucent Technologies, Inc	679,000,000	2000	4	2001	1	43	**Very Aggressive**	**1**
Motorola, Inc.	1,700,000,000	2000	1	2001	2	39	**Very Aggressive**	**6**
Qwest Communications International	144,000,000	2000	2	2002	1	47	Aggressive	**2**
Vivendi Universal	1,500,000,000	2000	4	2002	3	39	**Very Aggressive**	**3**
AOL Time Warner, Inc.	417,000,000	2001	2	2002	2	29	**Very Aggressive**	**5**
Healthsouth Corporation	2,700,000,000	2002	1	2002	3	64	Average	0
Global Crossing, Ltd.	1,480,000,000	2004	1	2004	2	54	Aggressive	0

Source: Audit Integrity "Top 20" analysis, October, 2005

Using forensic evidence to identify fraudulent behavior allows Audit Integrity to alert stakeholders in time to avoid losses when corporate crime is finally uncovered through litigation or an enforcement action, resulting in plummeting stock price. Protection of the stakeholders is the explicit purpose of the information provided by Audit Integrity.

When looking to identify and avoid companies that lack transparency in their reported financials and corporate behavior, recognize that you are not likely to find the CEO or CFO with the smoking gun in their hands. Forensic analysis relies on identifying a series of trace elements – a pattern of behavior – that will ultimately prove decisive in identifying fraud and misrepresentation. That is the basis of the AGR, which has proven to be the best measure of fraud-related risk in the market.

Audit Integrity provides unique insight into managing risk. For more information please contact us at:

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