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Appraisal of Forensic Investigation and Auditors' Liability: Empirical Evidence from Nigeria

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Abstract:

The evidentiary nature of forensic investigation is indispensable in detecting irregularity and ensuring quality audit and compliance. It will be hard to discern whether the auditor was negligent or duped by a tightly-knit conspiracy of insiders. This is because the procedures followed by an auditor may neither be inappropriate nor the audit client is mischievous. The polarity of auditors' liability to third party and audit quality was also an issue of contention. In view of these, the survey research design was adopted and data were collected from 509 respondents of selected Banks in Nigeria. Hypotheses were tested using Spearman's Correlations Coefficient and OLS. It was discovered that forensic investigation is significantly associated with auditor's liability; and that auditor's liability to the third party could improve audit quality. It was therefore recommended that forensic investigation should be carried out occasional not only when there is a suspicion of fraud or irregularity.

Keywords: *Forensic investigation, auditors' liability, audit quality, due diligence*

1. Introduction

The art of deliberate deception for unlawful gain is as old as human existence, and has persisted unabatedly even under the watchful eyes of the external auditor who is expected to be liable to all stakeholders in the gathering of relevant and reliable audit evidence to support the expression of an opinion on the accounts.

In recent times, accounting information had been maneuvered by some mischievous management to conceal misappropriated corporate assets. Marcus (2010) also added that one in every three employees is actively engaged in some form of Accounting fraud or embezzlement. Whereas the external auditor - who is not a spirit - appointed to bring his proficiency to bear, was unable to detect such fraudulent activities which amount to loss of investment and subsequent litigation against him. This exposure however, requires forensic investigative skills in inquiring into such a matter that the outcome will have application to a court of law.

It is true that external or statutory audits are also undertaken to ensure that the instituted fraud control mechanisms are adequate in scope, effective in application and complied with. However, it is rather unfortunate to note that the complexity of the human brain and the dynamic method of reasoning have tremendously diversified present day seams away from the hitherto known modes of fraudulent activities that now render true corporate governance ideals almost unworkable (Arens, Elder & Beasley, 2006). The failure of statutory audits to prevent and expose misappropriation of corporate fund has put pressure on the accounting profession to find better and urgent way of exposing and certifying financial crime which is called forensic Auditing or investigation.

Forensic investigation is the practice of lawfully establishing evidences and facts that are to be presented in a court of law. Forensic engagements are thorough examination of pertinent documents initiated to prove or disapprove that a crime has been or is being committed by a colleague or co-worker (Jackson, 2005).

A problem with extorting loans and credit arises, when investors and creditors rely on an unqualified audit opinion prepared by an accountant, and is thereafter faced with an insolvent debtor who has defaulted on its payment obligations; and because the business fails, the question becomes whether the audit opinion was, in fact not accurate and if not accurate whether the audit was negligently carried out by the auditor, which might propel a forensic investigation to the determination of the auditor's fate.

It follows therefore, that independent auditor does not only perform audit services to his/her clients, but also to third parties who rely on the auditor's statement when making financial decisions. This responsibility creates a unique relationship between the

auditor, the client and interested third parties. In the light of this, there are debates and controversies in courtrooms and among academia and the general public on what should be the scope of auditors' liability for negligent misstatement when discovered through forensic investigation. Some auditors have often convinced the courts to dismiss them at an early stage, while private litigants are dusting off other cases and pursuing litigation strategies that have the potential to expand the scope of auditor liability in order for it to have a robust effect on audit quality. To this end, the following hypotheses were tested:

- H₀1: Forensic investigation is associated with auditors' liability to the third party
- H₀2: Auditor's liability negatively affects audit quality.

2. Forensic Investigation and the scope of Auditor's Liability

Forensic investigation is about the determination and establishment of fact in support of legal case. It is the use of forensic techniques to detect and investigate a crime and to expose and identify all culprits (Degboro & Olofinsola, 2007). It is actually the integration of accounting, auditing and investigative skills that has yielded the specialty known as forensic accounting (ICAN, 2010).

Zysman (2008) also added that forensic investigation is the utilization of specialized investigative skills in carrying out an inquiry conducted in such a manner that the outcome will have application to a court of law". Forensic audit reduces fraud risks (Srivastava, Mock & Turner, 2003). Brown, Aiken, and Visser (2007) further added that, proactive forensic data analysis using computer based sophisticated analytical tests can detect fraud that may remain unnoticed for years. It provides an accounting analysis that is suitable to the organization which will help in resolving the disputes that arise in the organization. For example, litigation relating to "loss of business purportedly occasioned by auditor's professional negligence; would require forensic investigation to ascertain the external auditor's fate.

The procedures followed by an auditor may not be transparent, much less the quality of the audit performed at an individual company. It will be hard to discern whether the auditor was negligent or duped by a tightly-knit conspiracy of insiders; and this difficulty in assessing the audit firm's average audit quality will be made significantly harder when a particular audit team deviates from the firm's established procedures (Christian, Mathew, Foley & Boston, 2008).

In sum, consumers of audited reports may have difficulty distinguishing rigorous audits from sloppy ones. By so, auditors will not be able to capitalize fully on their efforts to do a thorough audit, which may tempt the auditor to cut corners in the audit. Cutting corners reduces the auditor's expense, thereby bolstering the auditor's profit margin. Even if the firm avoids such temptations, employees of the firm will face a similar temptation to cut corners, particularly in the face of client pressure. Monitoring to discourage agency costs of this sort is likely to be expensive and far from foolproof. All of which requires forensic investigation to ascertain the level of negligence.

Negligence is an act of omission which occurs because the person concerned failed to exercise that degree of professional care and skill, appropriate to the circumstances of the case, which is expected of an auditor. Claims for negligence or liability generally arise when an auditor has failed to discover a defalcation or fraud and the company has suffered financial loss subsequent to the audit. The remedy is generally damaged which means that the auditor is liable for his remissness. Actions for negligence may also be brought by third parties who have no contractual relationship with the wrong-doer (Adeniji, 2004). Although, as at the early part of this century, an auditor's liability for negligence or fraud in performing the attest function was limited mainly to the client; recently, auditor's liability has extended to include third parties.

2.1. Auditor's Liability and Audit Quality

The expansion of the auditors' liability has a significant hold on auditors' responsibility. The quality of the audit may not be readily apparent to the intended audience for the auditor's attestation, but the fact that if any goes wrong in terms of gross negligence, the auditors will be expected to pay for damages to its client and third party. Third parties do rely on the integrity of audited accounts and would seem right that a legal liability should reflect that. Third party in this context means anyone other than the company (audit client) who wishes to make a claim for negligence. Third parties therefore include any individual shareholders, potential investors, Banks and key financiers of the company etcetera.

External auditors are paid and therefore be accountable even to third party. According to Adeniji (2004), the auditor owes a duty of care to parties other than client if one has been established. They are to exercise sufficient directive, supervision and review of works at all level to provide reasonable assurance. It also requires the exhibition of duty of care and application of skills and competence; while adequate and operational effectiveness of quality control policies and procedures that is designed in accordance to international standard of auditing is fully implemented.

Millichamp (2002) affirmed that where the company suffers loss because of the auditors' negligence then the current existing legal remedy by the company against the auditor is appropriate. If the directors overstate the assets and the auditor fails to discover this then the company does not suffer loss. However, shareholders and other third parties may suffer loss and it seems right that they should be able to recover this from the auditors, as soon as it is tenable by forensic investigation. Specifically, if liability is not extended to third parties, the value attached to the audited financial statement might be questionable by them. There is no need for the auditor to exercise skill and care and the accounts are not reliable and are of little benefits

The problem of assessing audit quality is also been aggravated however, by the recent push to make accounting standards reflect fair value measurement as established in IFRS 13 rather than historical costs. An audit focused on making sure that assets have not been misappropriated by management is a manageable task and is reasonably likely to succeed. An audit attempting to determine whether the value of the corporation is accurately represented is much more likely to fail because there are so many variables that go into such a valuation, and many of those variables are vulnerable to subjectivity in measuring them.

In sum, auditors who worth their salt and conscious of their liability to third parties would do everything humanly possible in ensuring they carry out their responsibilities with utmost good faith while exhibiting due professional care, integrity, diligence and competence in the development of a quality audit.

3. Research Methodology

The study adopted ex-post facto research design while the population of this study was made up the 8 Nigerian Rescued (Commercial) Banks. These Banks were rescues due to the forensic and diagnostic reports on each of the banks which confirmed a pattern of bad corporate governance and fraudulent activities in the Banks by the sacked Chief Executives coupled with others range of crimes including theft, fraud and money laundering, while the sampled Banks studied were the three Nationalized Banks, namely; Keystone Bank (formally Bank PHB), Mainstreet Bank (Afribank) and Enterprise Bank (Spring Bank). These Banks were considered appropriate due to their peculiar natures among the rescued Banks in the Nigerian financial system. The sample size after due application of the Taro Yamane sample size determination on an estimated population size of 14,812 was 400. However to cater for inadequacies of low response rate, the sample size was increased to 550 respondents. The respondents were made up of shareholders, employees and auditors of the Banks who had knowledge of the instrument used. A questionnaire was however developed on 4-point likert scale. Spearman's Correlations Coefficient and Ordinary Least Square (OLS) for the hypotheses tests.

4. Research Results and Findings

Basically 509 responses were gotten from the 550 questionnaires sent out, which indicates 93 percent response rate, which was used accordingly, to appraise forensic investigation and auditors' liability to the third party and how the scope of Auditor's liability affects audit-quality.

The information collected from the respondents is presented below using percentages, mean and standard deviation.

Questions	SA	A	D	SD	Total
Forensic investigation is essential for audit quality.	117 23.0%	215 42.2%	105 20.6%	72 14.1%	509 100%
Forensic Investigation is the most effective for detecting corporate Frauds and averting it.	77 15.1%	349 68.8%	39 7.7%	44 8.6%	509 100%
A reduction on auditors' liability will negatively affect audit quality	160 31.4%	236 47.0%	107 21.0%	3 0.6%	509 100%
Audit quality depends on how far the auditor is liable when found wanting	105 20.6%	171 33.6%	134 26.3%	99 19.4%	509 100%
Audit quality depends on how far the auditor is liable when found wanting.	229 45.0%	129 25.3%	89 17.2%	62 12.2%	509 100%
Absolute reliance on audited financial statements depends on the quality of audit.	139 27.3%	191 37.5%	105 20.6%	74 14.5%	509 99.9%

*Table 1: Responses on Forensic Investigation, Auditors' Liability and Audit Quality
Field survey, 2014*

The data from item 1 on table 1 shows that more than 65 per cent of the respondents were in support of the fact that forensic investigation is essential for audit quality. Item 2 shows that over 80 percent of the respondents affirmed that forensic investigation is most effective for detecting and averting corporate frauds. Item 3 show information on the extension of auditors' liability to his client. It was however discovered that over 75 percent either agreed or strongly agreed that auditors' liability should be extended beyond his client – to the third party. Response of item 4 shows that more than 50 percent of the respondents consented that a reduction on auditors' liability will negatively affect audit quality. Item 5 shows that 70.3 percent of the respondents affirmed that audit quality depends on how far the auditor is liable when found wanting; while item 6 shows that 64.8 percent of the respondents consented that Absolute reliance on audited financial statements depends on the quality of audit.

Hypothesis One

- H_0 : Forensic investigation is not associated with auditors' liability to the third party
- H_1 : Forensic investigation is associated with auditors' liability to the third party

The Pearson Product Moment Correlation Coefficient was used for the test and the results are as presented below:

			Forensic investigation	Auditor's liability
Spearman's rho	Forensic investigation	Correlation Coefficient	1.000	.585**
		Sig. (2-tailed)	.	.000
		N	509	509
	Auditor's liability	Correlation Coefficient	.585**	1.000
		Sig. (2-tailed)	.000	.
		N	509	509

** . Correlation is significant at the 0.01 level (2-tailed).

Table 2: Spearman's Correlations Coefficient
Source: SPSS analysis, 2014

The statistical analysis shows that there is an association between forensic investigation and auditor's liability. This revealed a figure as high as .585** and equally significant at 0.01 level. We therefore reject the null hypothesis and accept the alternative hypothesis which stated that forensic investigation is associated with auditors' liability to the third party.

Hypothesis Two

- H₀: Auditor's liability negatively impact on audit quality
- H₁: Auditor's liability positively impact on audit quality

This hypothesis was tested using OLS and the result is as presented below:

Model		R	R Square	Adjusted R Square	Std. Error of the Estimate		
dimension0	1	.760 ^a	.578	.578	.83781		
a. Predictors: (Constant), auditor liability							
b. Dependent Variable: audit quality							
Table 3: Model Summary							
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.	F
		B	Std. Error	Beta			
1	(Constant)	1.416	.113		12.501	.000	159 7.4 72
	Auditor liability	.771	.019	.760	39.968	.000	
a. Dependent Variable: audit quality							

Table 4: Coefficients^a

Source: SPSS analysis, 2014

The statistical analysis shows that there is a positive relationship between the auditor's liability and audit-quality. The t-statistics of 39.968 was positive and higher than the cut-off point of 2.37 [$t_{cal} = 39.968 > t_{0.05} = 2.37$]. Same can be said of the F-value which was relatively high. Our R² value also shows that 58 percent of the variation in audit quality can be explained by the scope of auditor liability to third parties. We therefore reject the null hypothesis and accept the alternative hypothesis which stated that Auditor's liability positively impact audit quality.

5. Summary of finding, Conclusion and Recommendations

The study dwells on forensic investigation and auditors' liability. It reveals that, there is a significant correlation between forensic investigation and auditor's liability, as the knowledge of forensic investigation can reduce corporate fraud and assist in liability mitigation, and that Forensic investigation is the most effective means of detecting corporate fraud; and this basic knowledge is essential for company auditors.

Discovered also was that the extent of auditor's liability to the third party for negligent misstatement revealed through forensic investigation could improve audit quality while limiting the scope of auditor's liability. The results corroborate with extent literature such as Adeniji, (2004) and Owajori & Asaolu (2009) who specified that Actions for negligence may also be brought by third parties who have no contractual relationship with the wrong-doer.

Forensic investigation is a necessary tool to reveal inefficiency in the organization's operations and auditing process, and Public accountants must embrace all possible measures to minimize the possibility of a liable suit. Where such suits exist and the auditor acquainted, his reputation suffers heavily as well as the reputation of his firm.

An increase in auditors' liability impact on audit quality which further spur the reliability and quality of financial reporting; with this, auditors will exhibit due professional care, integrity, diligence and competence in the development of quality audit. It was therefore recommended that forensic investigation should be carried out occasional not only when there is a suspicion of fraud or where litigation is brought against the company; as the fear of forensic investigation is the beginning of wisdom to eschew all forms of corrupt practices by organizational staffs; and by extension limiting all forms of exposure faced by the external auditors. External auditors should strive for clarity and completeness at all times and should take Liability insurance. Though, this by no means provides the needed solution to the auditor's problem, but it does offer partial protection. They should also limit their exposure by choosing words to be included in the engagement letter carefully and avoiding ambiguous words, and making sure the phrase "exclusion of punitive damage" is included in the engagement letter. This will indeed avoid a substantial amount of clients and third party liability.

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