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What is Forensic Finance?

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Foundations and Trends® in Finance

Published, sold and distributed by:
now Publishers Inc.
PO Box 1024
Hanover, MA 02339
United States
Tel. +1-781-985-4510
www.nowpublishers.com
sales@nowpublishers.com

Outside North America:
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PO Box 179
2600 AD Delft
The Netherlands
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The preferred citation for this publication is

J. M. Griffin and S. Kruger. *What is Forensic Finance?*. Foundations and Trends® in Finance, vol. 14, no. 3, pp. 137–243, 2024.

ISBN: 978-1-63828-419-2

Foundations and Trends® in Finance
Volume 14, Issue 3, 2024

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Foundations and Trends® in Finance, 2024, Volume 14, 4 issues. ISSN paper version 1567-2395. ISSN online version 1567-2409. Also available as a combined paper and online subscription.

Contents

What is Forensic Finance?

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ABSTRACT

We survey a growing field studying aspects of finance that are *potentially* illegal, illicit, or immoral. Some of the literature is investigative in nature to uncover malfeasance that is recent and possibly ongoing. Other forensic finance research examines past events to generate a fuller understanding of the activities, economic magnitudes, incentives, and players involved. The work spans newer areas such as cryptocurrencies, financial advisor and broker misconduct, and greenwashing; and newer research in established fields that are still developing, such as insider trading, structured finance, market manipulation, political connections, public finance, and corporate fraud. We highlight investigative forensic finance, common economic questions, common empirical methods, industry and political opposition, censoring, and the importance of avoiding publication biases. Compared to other finance papers, forensic work has similar citations and SSRN downloads, and more media and Securities and Exchange Commission (SEC) citations. Along with prominent examples of industry reform and awareness, this highlights the potential for real-world impact. By laying out commonalities in research themes, questions, methods, and

John M. Griffin and Samuel Kruger (2024), "What is Forensic Finance?", Foundations and Trends® in Finance: Vol. 14, No. 3, pp 137–243. DOI: 10.1561/0500000073.
Online Appendix available from: http://dx.doi.org/10.1561/0500000073_app

approaches across fields that may at first seem disparate, we hope to encourage more investigation of incentives and mechanisms in darker corners of finance.

Keywords: Fraud; manipulation; misreporting; malfeasance; conflicts of interest
JEL Codes: G18, G28, G38, G59

1

Introduction

One needs only to open a newsfeed to realize that financial shenanigans, fraud, and other forms of financial malfeasance are constantly in the headlines. From the spectacular collapse and disappearance of crypto at the second-most popular crypto exchange (FTX), to various Ponzi and pump-and-dump schemes and accusations of hedge funds manipulating markets, a quick perusal of financial news indicates that there is an ample supply of such activities. Cost ranges of financial fraud are noisy but typically vary between three and nine percent of GDP (Gee and Button, 2019). What does academic research have to say about the prevalence, magnitude, and economic mechanisms regarding potentially nefarious activities in finance?

Newspapers that fund investigative journalism have experienced a recent decline (Turkel *et al.*, 2021), but the top finance journals are dedicating substantial space to investigative and forensic topics, and there appears to be a growing awareness of the importance of these topics. Forensic finance encompasses a wide range of subject areas, and researchers may not fully realize the connections across diverse forensic topics. Additionally, forensic research varies widely in the nature and timeliness of events, the empirical methods being used, and the legality, magnitude, and economic incentives of the conduct being investigated. Nonetheless, there are important common themes across forensic topics.

From talking to many professors and PhD students, we see an interest in examining forensic areas in finance but limited understanding of where to start, how to weave an interesting practical examination into an academic exercise, and whether there will be sufficient academic interest. There is also little sense of how examinations of different markets may relate to one another. One of our main goals from this review is to highlight common themes and purposes in this field that can hopefully provide ideas to encourage future research with the possibility of real-world impact.

What is Forensic Finance? The term forensic finance is not widely used but is related to the more well-known field of forensic accounting. In contrast to forensic accounting, which often focuses on the auditing of financials, forensic finance uses knowledge of specific financial areas along with multidisciplinary methods from econometrics, statistics, and data science to investigate forms of potential malfeasance that are of a financial nature or related finance. We define the field of forensic finance as the examination of anything that is *potentially* illegal, illicit, or immoral in financial markets. The examined events may or may not be illegal and could be proven or disproven by the research. We view this definition as a useful way of describing the growing body of research summarized in this monograph, but we also note that others may describe this field with different names, and the term forensic finance does not have a settled definition.

Investigative forensic finance is a branch of forensic finance that focuses on recent or ongoing activity that is potentially nefarious. The questionable activity may have been previously unknown or may have been rumored or reported to have occurred but with a limited understanding of the scope, facts, players, and economic incentives. Since financial malfeasance is often hidden within the most complex and opaque areas of finance, thoughtful analysis and innovative data collection are often central to good forensic research. Additionally, it is important for researchers to be objective, open to academic debate, and to report non-results for investigations of financial matters that are rumored to be happening but may or may not be actually occurring.

Whereas investigative journalists mainly learn from limited observations and interviewing participants in a market, investigative finance follows the forensic "tracks" in the data, tests alternative hypotheses, and in general digs much deeper.

A common and growing concern about business school research is that much of it lacks tangible, real-world impact on society. For example, a group of leading business school scholars, editors, and deans trying to address the issue states, "With a few notable exceptions, scholarly research rarely reaches the worlds of business or policy, and academic journals are neither read nor cited widely beyond the academic community" (Glick *et al.*, 2018).[1] Similarly, Hoffman (2021) notes that there is a growing concern that academic research is becoming "increasingly irrelevant" and "insular" but also notes a shift among younger scholars that wish to "contribute to the real world" and "make a difference." More broadly, Sarewitz (2016) details how science "advances most rapidly, and is of most value, when it is steered to solve problems" with "direct engagement with the real world" as opposed to focusing on publication of incremental new results in unrealistic lab settings.[2] While one response to the lack of practical impact is for universities to decrease the weight they put on publications in top journals (Hoffman, 2021), forensic finance research shows a path on which publication success and practical impact often co-exist. Forensic finance addresses important economic questions with the rigor and academic interest to be publishable in top finance journals while also being of interest to

[1] A recent continuation of this movement can be seen with the session for business school deans on "Increasing the Impact of Faculty Research" at Emory's March 20 and 21, 2023 Business School Dean's Summit. Along the same lines, the *Financial Times* business school ranking team is exploring how to assess research's "resonance with a broader audience and applicability to societal needs" (see https://www.ft.com/content/7cf1deb9-f8dd-498e-9cab-e8bf3a615ee9). In conversations with fellow finance academics, many colleagues express concerns about how useful some finance research is to society. An additional complexity is that real-world impact of academic research is difficult to measure and there are many avenues of potential impact.

[2] Sir Leszek Borysiewitz, vice chancellor of the University of Cambridge writes, "Universities in turn are charged with holding a mirror to society — a duty that sometimes requires institutions of higher learning to speak 'unpalatable truths' that society might not want them to hear" (Merchant, 2017).

practitioners, journalists, regulators, and the general public.[3] Forensic finance may provide a roadmap for other areas of research to have both academic and practical impact.

We show descriptive statistics about the publication, citations, and media of 6334 papers in the top three finance journals from January 2000 to April 2023. While it is difficult to precisely categorize forensic papers, 6.7% of papers published in the top 3 finance journals exhibit concentrated use of forensic words. Papers with forensic words have similar Google Scholar citations and slightly more SSRN downloads. Forensic papers have substantially more SEC citations and more media attention, indicating that they may be influencing SEC policy and could have a deterrent effect against nefarious activities. Perhaps not surprisingly, most of this impact is by a small set of papers. As an example of a paper with a seemingly large measurable impact, Egan *et al.* (2019) documented the players and incentives in the financial advisor misconduct records, which led to substantial media scrutiny of financial advisor companies and changes to processes used by the SEC, the state of Massachusetts, and the Financial Industry Regulatory Authority (FINRA).

In addition to directly impacting nefarious activity, forensic research can also provide a useful balance to other finance research. In particular, academic research (as well as media coverage) about new markets and technologies (such as crypto and FinTech) may inadvertently slant toward their potential benefits. Forensic finance can potentially serve as a counterweight by examining what is happening at the ground level. Nevertheless, as with many fields, a perceived publication bias towards shocking findings combined with open-ended methods of examination can also potentially lead to a publication bias. This is why we emphasize the importance of "*potentially*" in defining the contours of forensic finance. Non-results can be informative too, and we point to papers (including our own) that examined potentially nefarious activities and convincingly find no such evidence. We also highlight potential

[3] In some cases media coverage and practitioner summaries can help to bridge this gap. For example, Toffel (2016) notes that one avenue of impact is "attracting the interest of those who write columns, blogs, and articles about research for practitioners."

opposition to research from industry players and the importance of revealing the firm names of responsible parties to foster public scrutiny and practical change.

This monograph builds upon important earlier surveys of forensic economics by Zitzewitz (2012) and forensic finance by Ritter (2008).[4] Karpoff (2021) examines whether financial fraud, largely corporate fraud, is becoming larger or smaller over time. Griffin (2021a) surveys the academic literature surrounding the role of fraud in the financial crisis. A vast literature has developed since these prior surveys, with the nature of the questions, topics, and types of evidence shifting considerably along with the growing financial environment. For example, Ritter's survey focused on mutual fund late trading, option backdating, initial public offering (IPO) allocations, and the changing of a database of analyst coverage. We examine academic studies involving financial reporting misconduct, financial market misconduct, financial advisor misconduct, and public finance misconduct. Examples include corporate fraud, structured finance, greenwashing, cryptocurrencies, market manipulation, insider trading, public corruption, tax evasion, and more. We focus on recent forensic finance research in areas that have not been widely surveyed with less focus on areas of forensic economics (Zitzewitz, 2012), such as price collusion and healthcare fraud, or forensic accounting (Honigsberg, 2020), although we see the intersection of these areas and finance as ripe for potential research.

By focusing on forensic finance, we do not wish to leave readers with the impression that finance is negative for society. On the contrary, finance is enormously beneficial, but its role in allocating resources is more effective when there are fewer frictions from malfeasance. Trust is also a necessary ingredient for participation in the financial system (Guiso *et al.*, 2008). Exposing malfeasance can enhance trust both by eliminating misconduct and by increasing transparency for financial

[4] Khwaja and Mian (2011) also survey some common agency issues in the literature on corruption and rent seeking in financial markets. Alexander and Cumming (2020) provide chapters written by different authors on market manipulation, insider trading, and other forms of misconduct. Cumming *et al.* (2015) survey the literature on causes and consequences of financial market misconduct. Amiram *et al.* (2018) survey the literature on corporate financial reporting fraud.

interactions that are free from misconduct. Zingales' (2015) presidential address argues that corruption and other forms of financial malfeasance have colored the perception of the finance field and that finance academics need to carefully consider their research and teaching on these important topics. We hope that this monograph will provide context and mechanics to move toward the goal of adding more transparency to potentially nefarious activity in finance. We highlight the ways in which forensic finance has brought additional clarity to different areas of finance, and we include thoughts on areas for future research. This starts by understanding the mechanics of how a market functions, identifying potential conflicts of interest within the market, and assessing whether the market is properly functioning. In a world with increased complexity, polarization, and distrust, detailed and objective academic research on forensic topics can help restore integrity and trust to our global financial system.

The survey is broken down into three main pieces. First, we identify forensic papers published in top finance journals to broadly describe the field and its potential impact. Second, we summarize common themes and suggestions for impactful work. Third, we review important recent forensic research, organized by four main topic areas: financial reporting misconduct, financial market misconduct, financial advisor misconduct, and public finance misconduct. Financial reporting misconduct includes misreporting by corporations and investment firms, misreporting and related issues in structured finance (e.g., residential and commercial mortgage-backed securities), and misreporting of environmental, social, and governance measures, often referred to as greenwashing. Within financial market misconduct, we discuss cryptocurrencies, market manipulation, and insider trading. Financial advisor misconduct consists of fraud and other forms of misconduct by brokers and other financial advisors. Within public finance misconduct, we discuss public corruption, tax evasion, and government program fraud. We conclude with suggestions for future research and thoughts on how to shape the future of forensic finance.

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