

Chapter 1

Introduction to Forensic and Investigative Accounting

CHAPTER SUMMARY

Overview

This chapter defines a broad approach to forensic accounting and creates a frame of reference for students to read and understand the rest of the book. Upon tracing the threads of forensic accounting through its history and development, students will understand forensic accounting to be a challenging discipline that substantially interacts with economics, finance, information systems and the law.

Definition and Development of Forensic Accounting

¶1001 Defining Forensic Accounting

Forensic accounting is the action of identifying, recording, settling, extracting, sorting, reporting, and verifying past financial data or other accounting activities for settling current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes.

Implicitly, there are a couple of other factors to incorporate in the definition: time and purpose. Forensic accounting focuses on the past, although it may do so in order to look forward. Forensic accounting is accounting performed in some circumstances for a specific legal forum; in other circumstances it is accounting performed in anticipation of presentation before a formal forum.

Forensic accountants may be employed in a wide variety of risk management engagements, along with areas such as valuation, damages, intangibles, and so on.

¶1011 Historical Roots of Accounting

The history of accounting dates back to temple priests taking inventory of livestock and has evolved through time to such present events as the examination requirements for the CPA certificate being passed by all states.

¶1021 History of Financial Reports and Legal Challenges

Financial reports on business operations and performance were created by accountants in the United States, Canada, and Europe for a long time before actual independent audits were mandated. The current system of accounting checks and balances—financial reporting coupled with both internal and external auditing—is relatively recent. Before financials were audited by independent outside experts, the courts were often the place where challenges were made and accounting experts were brought in to give testimony on the disputes in question.

¶1031 Threads of Forensic Accounting

Forensic accounting (or at least, accounting expert witnessing) can be traced as far back as 1817 to a Canadian court decision of *Meyer v. Sefton*. Thus, the website of the Association of Certified Forensic Investigators of Canada maintains that the field of forensic and investigative accounting had its genesis in Canada. Seven years after the Canadian case, on March 12, 1824, a young accountant by the name of James McClelland started his business in Glasgow, Scotland, and issued a circular that advertised the various classes of forensic-type work he was prepared to undertake.

¶1041 Accounting Literature Parallels Accounting Practice

With the development of accounting literature the role of the accountant as an expert witness was getting growing attention. Articles on the topics of forensics, arbitration, fraud, investigation, and expert witnesses started appearing in the late 19th century. Cleveland Bacon and Alex Moore each contributed articles about expert witnesses.

¶1051 The Phrase “Forensic Accounting” Is Born

The first person to coin the phrase in print was probably Maurice E. Peloubet in 1946. Kenneth W. Robinson suggested that there is teamwork to be done by lawyers and accountants. In the following year, George B. Pearson, Jr., a former judge, gave 10 warnings to the accountant who wishes to do a good job on the witness stand. Max Lourie, a lawyer employed in the New York Supreme Court published an article in which he suggests that he probably invented the term forensic accounting, although his article appeared seven years after Maurice E. Peloubet had apparently coined the term. In 1964, Philip J. Gallagher in the *Journal of Accountancy* suggested that an accounting expert witness must be able to define the basic concepts of the profession and be able to explain accounting terminology.

Forensic Accounting and Investigative Accounting Come of Age

¶1061 The Forensic Accountant Becomes an Investigator

Once accrual accounting took hold and the role of external auditor became much more broad based and control-oriented than transaction-oriented, there developed a need for a fraud auditor—a specialist who would ferret out deception in financial statements and reporting. Gradually the definition of forensic accounting expanded from the accountant who testifies in court to the investigative accountant as Peloubet chronicled. The forensic accountant learned to detect fraud itself, not merely to testify about it. Perhaps nowhere is this more evident than in the use of accountants and forensic accounting skills by the FBI.

¶1071 FBI and Forensics

According to Lee R. Pennington, during the period of hostilities in WWII, the FBI employed a total of 500 agents who were accountants. In 1960, J. Edgar Hoover began to emphasize fraud detection. Agents investigated violations of the Federal Reserve Act, check kiting, embezzlements, fraud in government contracts, criminal investigations under the National Bankruptcy Act, various civil investigations, fraudulent check schemes, securities frauds, confidence game swindles, embezzlements, false bills of lading, fraudulent bankruptcies, false claims, and various frauds perpetrated against the government. Today there are more than 600 FBI agents with an accounting background, and many are CPAs. The FBI today has a Financial Crimes Section that investigates money laundering, Internet crimes, financial institutions fraud, and any other economic crime.

¶1081 First Forensic Accounting Books in United States

The first forensic accounting book appeared in 1982, written by Francis C. Dykeman, a retired partner of Price Waterhouse. Four years later in 1986, Kalman A. Barson published a second forensic book entitled *Investigative Accounting*. In 1987, a third book was published entitled *Fraud Auditing and Forensic Accounting: New Tools and Techniques*.

¶1091 AICPA Practice Aid

In 1986, the AICPA broke forensic accounting into two broad areas: investigative accounting and litigation support. The Institute issued Practice Aid 7, which outlined the six areas of litigation services: damages, antitrust analyses, accounting, valuation, general consulting, and analyses.

¶1101 American Management Association Course

The American Management Association now offers a self-study course, “Forensic Accounting and Financial Fraud,” which breaks forensic accounting into four broad areas: pretrial support, trial support, expert witnessing, and settlement support.

¶1111 The Panel on Audit Effectiveness

The Public Oversight Board (an independent private sector body created in 1977) appointed the Panel on Audit Effectiveness in 1998 at the request of then SEC Chairman Arthur Levitt to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest. The Panel conducted the most exhaustive study ever undertaken of the audit model and on September 6, 2000, released a report of more than 200 pages entitled *Report and Recommendations*. The report's goal is to foster more effective audits that improve the reliability of financial statements, enhance their credibility, contribute to investors' confidence in the profession, and improve the efficiency of the capital markets.

¶1121 AICPA Fraud Task Force Report

In 2003, the AICPA's Litigation and Dispute Resolution Services Subcommittee issued a report of its Fraud Task Force entitled "Incorporating Forensic Procedures in an Audit Environment." The task force paper provides guidance to practitioners in applying procedures in an audit environment in light of the Sarbanes-Oxley Act and newly issued AICPA Statement on Auditing Standards (SAS) No. 99, Consideration of Financial Fraud in Financial Statement Audit.

The AICPA takes the position that auditors are not required to carry out specific forensic procedures, but rather provide guidance on how to include forensic techniques within the SAS 99 process. Public accountants may need to use forensic accountants in certain circumstances.

¶1131 Controversy Surrounding the Accountant's Role in Fraud Detection

In the early 1980s, companies began to use computers to perform their record keeping, and intense competition caused the auditing fees to fall as much as 50 percent from the mid-1980s to the mid-1990s. Thus, auditors had to cut costs by reducing the labor-intensive process of reviewing hundreds of corporate accounts. They grew more reliant on internal controls and worked less with account balances and entries. Because top executives can circumvent internal controls, they could manipulate the records and cook the books.

Accounting experts debate the role of auditors in uncovering fraud and hold many different views. Some believe that every audit engagement should include much more skepticism and detailed review of transactions. Others suggest that only special engagements specifically targeting fraud can adequately and effectively root out the problem.

¶1135 American Accounting Association Finally Permits a Forensic Section

A new Forensic and Investigative Accounting (FIA) section of the American Accounting Association was created in 2009 by Larry Crumley. This FIA section is dedicated to the continual improvement of forensic accounting research and education, through the encouragement, development, and sharing of:

- The promotion and dissemination of forensic and investigative academic and practitioner research.
- The relevant and innovative curricula with an emphasis on effective and efficient instruction.
- The exploration of knowledge-organizational issues related to forensic accounting programs.
- The creation and presentation of CPE courses to members and professionals.

¶1141 Conclusion

The computer helped direct a revolution in accounting because business transaction volume grew to such an extent that it was impossible for accountants to examine each transaction. Internal controls, determining risks, and sampling became the focus. Unfortunately, unethical managers learned to skirt the modern controls; thus, weaknesses in the modern risk control and sampling approach grew during the 1990s and became even more apparent in the first few years of the 21st century. For broad-based, system-wide relief from today's financial scandals, many suggest that the weaknesses can be attacked successfully in repositioning the auditing engagement and mandating more stringent ethical and independence requirements to start.

SOLUTIONS TO CHAPTER EXERCISES

1. In commerce or business, forensics are generally those things that relate to a legal forum or court. The term “forensic” is Latin, meaning forum, a public place, or court. Some use it interchangeably for fraud (i.e., forensic audit).
2. There are many definitions, such as the action of identifying, recording, settling, extracting, sorting, reporting and verifying past financial data or other accounting activities for setting current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes. Forensic accounting may be broken into two broad categories: investigative accounting and litigation supports.
3. Time (past), purpose (gather evidence for possible trial) and peremptory (both pro-active and reactive).
4. A forensic audit is often different than a typical financial audit. A financial audit is generally a sampling activity that does not look at every transaction. Thus, the system can be exploited by someone, such as an executive, who knows how to “cook the books.”
A forensic audit looks at the details of a specific aspect of the records, trying to determine why everything does not or should not add up. Thus, a forensic audit is much more time-consuming and can be significantly more expensive than a regular financial audit. Doug Carmichael, former Chief Auditor for PCAOB, faults auditors for not adopting forensic techniques. He wishes more tests of detail, not relying on tests of controls.
5. Hercules De Cordes, a schoolmaster and bookkeeper in Antwerp.
6. The IRS developed a number of indirect techniques to catch taxpayers not paying their taxes (e.g., net worth method, cash T, bank deposit method). An instructor may wish to discuss the Al Capone indictment.
7. Frank Wilson was assigned to investigate Al Capone. Wilson found the smoking gun in the form of an accountant’s cash receipts ledger showing net profits from a gambling house, with Al Capone’s name on it. Capone dealt in cash only.
8. Canada.
9. James McClelland, a Scottish accountant in Glasgow, Scotland in 1824.
10. Buscabeatas, a pumpkin and tomato farmer, who used the green stems from his stolen pumpkins to prove who had stolen his pumpkins.
11. New York State.
12. American Association of Public Accountants.
13. (a) Evidence, and (b) Arbitration and Awards.
14. England, 1856.
15. Arthur Andersen.
16. Enron (and also WorldCom).
17. Investigative accounting and litigation support.
18. Maurice E. Peloubet, a New York City accountant, in 1946.
19. Investigative-type accountants; forensic accountants; SEC accountants; FBI agents.
20. World War II.
21. J. Edgar Hoover.
22. Francis C. Dykeman, *Forensic Accounting: The Accountant as Expert Witness*, 1982.
23. *Investigating Accounting*, 1986, Katman A. Barson, Van Nostrand Reinhold.
24. *Fraud Auditing and Forensic Accounting: New Tools and Techniques*. Many of the behavioral considerations about fraud lurk beneath the surface like an iceberg, posing a danger to an unsuspecting auditor.
25. e. Decisions on the case.
26. Antitrust, commercial contracts, patent infringement, trademark and copyright infringement, product liability, mergers and acquisitions, insurance claims, shareholder suits, reorganization and bankruptcy, taxation, malpractice, and corporate fraud.

27. Students will need to find this answer on the Internet or in Chapter 4:

- Recounts of inventory items or unannounced visits to location.
- Interviews of financial and nonfinancial company personnel in different areas or locations.
- Requests for written confirmations from company employees regarding matters about which they have made representations to the auditors.
- Requests for written confirmations from customers or vendors that otherwise would not be undertaken and that are carefully tailored to address the nature and specific terms of the underlying transactions.
- Tests of accounts not ordinarily performed annually.
- Tests of accounts traditionally or frequently deemed “low risk.”

28. Complete answer found by searching the Internet, and also in Chapter 4.

The forensic-type fieldwork phase of an audit does not mean converting a traditional audit to a “fraud audit.” Rather, the characterization of this phase of an audit as a forensic-type phase seeks to convey an attitudinal shift in the auditor’s degree of skepticism, according to the Panel of Audit Effectiveness. During this phase, auditors should modify the otherwise neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of documents. The key question that auditors should ask is “Where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?” In this phase, auditing standards should require performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal controls by management. The tests should be centered on the balance sheet date for balance sheet accounts and throughout the year (including the latest quarter) for income statement accounts.

29. e. All of the above.

30. AICPA consulting standards.

31. Accountants stopped auditing the details and began looking at and auditing the controls. They began using computer programs and engaging in top-down auditing rather than bottom-up auditing. Executives learned how to skirt the modern controls. See the material about WorldCom and the \$647 million entry.

32. Xerox pumped up its earnings by placing into income certain cushion reserves originally established for other purposes. KPMG missed it, and the \$500 million was caught by an internal auditor (after the next auditor suggested there should be forensic-type audits in certain areas).

33. Arthur Andersen missed on their external audit of WorldCom the shifting of at least \$3.8 billion of operating expenses to capital accounts.

34. Students’ answers will vary. In early September 2009, 1.76 million hits were found on the Google search engine with the term “litigation support” and 617,000 hits with the term “litigation services.” “Accounting litigation services” returned 804,000 hits, and “forensic accounting” found 640,000 hits. “Fraud examination” returned 47,000 hits, and “accounting litigation support” found 940,000 hits. The terms were submitted with quotes.

35. This question requires students to visit the Kessler International website. Michael G. Kessler claims to be the first forensic accountant.

36. On Voldal Wartelle & Co. website:

Some folks described forensic accountants as the guys who come onto the battlefield after the war has been fought and shoot the survivors. We have a somewhat different view of it. Forensic accounting is the art of coming into the situation after the fact and carefully determining the financial effects of what happened or the reasons why a particular thing happened.

<http://www.vwc.org/pages/forensic.html>

On Investopedia.com:

Forensic accounting utilizes accounting, auditing and investigative skills to conduct an investigation into a company's financial statements in order to provide an accounting analysis that is suitable for court.

Sequence-inc says:

Forensic accounting is a specialty that integrates accounting, auditing, and investigative skills. An alternative term for this field of work is investigative accounting. A forensic accountant looks at documents in a critical manner to draw conclusions and calculate values. Forensic accountants often analyze insurance claims, calculate damages, and evaluate fraudulent situations.

<http://www.sequence-inc.com>

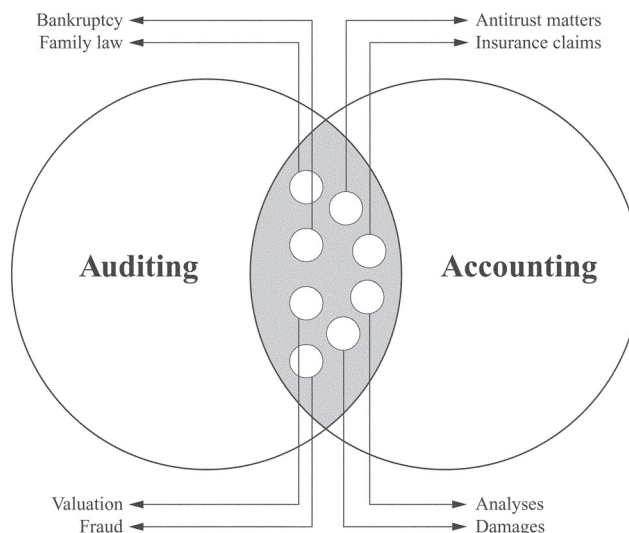
37. There is no formal answer for this question.
38. A student can find at least 25 colleges and universities that have a forensic accounting or fraud program. Some examples are:
- Carlow University
 - Florida Atlantic University
 - Franklin University
 - Georgia Southern University
 - Roosevelt University
 - University of South Florida, St. Petersburg
 - Utica College
 - West Virginia University
- A number of colleges and universities offer online courses.
- 39.
- a. 800 Chief Executives.
 - b. 84%.
 - c. Expense account.
 - d. Poor internal controls; collusion between suppliers, vendors, and employees.
 - e. Male, aged between 26 to 40 years, who has been with the company for less than two years.
40. There is no formal answer for this question.
41. As of mid-September 2009:
- a. 640,000
 - b. 113,000
 - c. 37,000
 - d. 47,000
42. No formal answer given. Internet game.
43. The Maxima Group gives as the main consequences of fraud (under corporate fraud):
- Financial loss.
 - Compliance and regulatory infringements.
 - Breaches of civil law, resulting in litigation.
 - Ruinous publicity (particularly when labeled as a "scandal" by the media).
 - Personal damage to the careers of even those managers not involved in the fraud.
 - Considerable disruption to the business and, in the worst cases, liquidation.

44. No formal answer given.
45. Plagiarism is fraud.
46. No formal answer given.
47. This report takes a very narrow position of the definition of forensic accounting, basically equating it to fraud investigation. We believe that forensic accounting's scope is much broader than fraud detection. Even in the area of fraud, a forensic accountant may be employed in a wide variety of risk management engagements within business enterprises as a matter of right, without the necessity of allegations. In other words, predication is not an absolute step in forensic accounting practice, so that the practice is preventive and proactive.

Regrettably, West Virginia University used a \$600,000 grant to develop a narrow Model Curriculum for training university students in fraud and forensic accounting. In fact, the report is an investigative curriculum and not a forensic curriculum. For example, the report gives nine "Model Curriculum Working Definitions" and eight of the nine involve fraud. The report does define forensic accounting as "the application of accounting principles, theories and discipline to facts or hypotheses at issue in a legal dispute and encompasses every branch of accounting knowledge." There are no definitions for valuation, damages, lost profits, lost value, litigation services, and so on.

A graphic provided in the report demonstrates the narrow approach taken, and one wonders how a 14-member planning panel could have accepted such a graphic. The report states that the "level of overlap between forensic accounting and fraud may be larger than depicted here." At least four of the 14 members of the planning panel were CFEs, and there were no representatives of Cr.FAs, CFDs, CFFAs, CVAs, or CFSs.

Although one may argue as to how small the fraud circle should be with respect to areas such as valuation, damages, bankruptcy, family law, general consulting, analyses, and anti-trust analyses (some of the 31 categories in the 1986 AICPA Practice Aid No. 7), a corrective graphic should appear somewhat as shown below.



48. James Edwards takes the broad approach. See question 47, also. We take the broad approach rather than a narrow approach.
49. A recent report called "Serving Global Capital Markets and the Global Economy" makes this statement.
50. The AICPA does not require auditors to carry out specific forensic procedures, but rather provides guidance on how to include forensic techniques within processes outlined in SAS 99. This combination will enhance the detection and prevention of fraudulent financial statement reporting and misrepresentation of assets, thus protecting investors and financial statement users.

Public accounting firms could use forensic accountants to help revise their approach to planning and fieldwork on all audits, while requiring forensic accountants only on high risk audit clients to aid in the interpretation of forensic testing results and preventive control enhancements.

51. d

52. b

53. c

54. a

55. e

56. a

57. d

58. d

59. The search results are:

- a. Robert Pfaff, ex-KPMG partner was sentenced to 97 months in prison and ex-KPMG senior tax manager was sentenced to 121 months after they were convicted on tax evasion charges billed as the largest tax-shelter fraud case in U.S. history (4-1-2009).
- b. Adrian Dicker, former chairman of BDO Seidman, pleaded guilty to tax fraud with respect to tax shelters. He faces a maximum sentence of five years (5-17-2009).

60. Answers will vary.

61. Answers will vary.