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## CHAPTER ONE

# Background of Fraud Auditing and Forensic Accounting

There's a sucker born every minute.

—*P. T. Barnum*

Trust everyone, but cut the deck.

—*P. T. Barnum*

## INTRODUCTION

In the first decade of the twenty-first century, the news has been filled with reports on frauds and indicators that it is increasing in its scope and costs to the U.S. economy. Almost everyone has read about corporate financial statement frauds such as Enron and WorldCom, or frauds against the government such as false claims following Katrina, or huge Ponzi schemes such as the Madoff scam that set a new record for losses associated with a fraud.

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Many people have been directly affected by identity theft. The economic downturn that began in 2008 has made it hard to rebound from such losses. To make matters worse, reports on activities related to fraud bear bad news.

A 2007 report from the Federal Bureau of Investigation (FBI) estimates that fraud in non-health insurance costs more than \$40 billion per year, or put another way, costs the average U.S. family between \$400 and \$700 per year in increased premiums!<sup>1</sup> In the same report, the FBI estimates that costs associated with fraudulent claims following the Katrina hurricane disaster accounted for as much as \$6 billion. The FBI also reports that suspicious activity reports (SAR) filed by banks increased 36 percent for 2008 over 2007. Of the SARs filed in 2007, 7 percent indicated a specific dollar loss, which totaled more than \$813 million.<sup>2</sup> The FBI was investigating over \$1 billion in mortgage frauds in 2008.<sup>3</sup> All these facts existed *before* the economic meltdown and scrutiny brought to the subprime mortgage industry.

The Internet Crime Complaint Center (IC3) is a federal watchdog agency formed as a partnership of the National White Collar Crime Center (NW3C) and the FBI that serves as a center to receive, process, and refer criminal complaints regarding the rapidly expanding area of cybercrime. Its *2008 Annual Report* shows a 33 percent increase in complaint submissions over 2007, which is the trend over this decade. The total losses from 2008 complaints were \$265 million with a median loss of \$931,000 per complaint.<sup>4</sup>

The National Insurance Crime Bureau (NICB) says that 10 percent of all property or casualty insurance claims, 15 percent of auto theft claims, and 20 percent of workers' compensation claims involve some form of fraud. According to the NICB, auto insurance theft costs \$20 to 30 billion a year. The NICB reports that questionable claims reports in the first half of 2009 has increased 13 percent over first half of 2008 and the numbers in nearly all referral categories are rising as well.

The Association of Certified Fraud Examiners (ACFE) provides periodic surveys of fraud and reports the results to the public in its *Report to the Nation* (RTTN). Results were published in 1996, 2002, 2004, 2006, and 2008. The 1996 RTTN reported an estimate of over \$400 billion in losses due to fraud, which increased over the years to an estimated \$994 billion in 2008. Fraud clearly continues to cost organizations and society huge sums of money, both recently and throughout the history of commercial business.



## BRIEF HISTORY OF FRAUD AND THE ANTIFRAUD PROFESSION<sup>5</sup>

According to some, forensic accounting is one of the oldest professions and dates back to the Egyptians. The “eyes and ears” of the king was a person who basically served as a forensic accountant for Pharaoh, watchful over inventories of grain, gold, and other assets. The person had to be trustworthy, responsible, and able to handle a position of influence.

In the United States, fraud began at least as early as the Pilgrims and early settlers. Since early America was largely agricultural, many frauds centered around land schemes. Perhaps the most infamous colonial era land scheme was the purchase of Manhattan Island (what is now Brooklyn), bought from the Canarsie Indians. The land was bought for trinkets worth about \$24. In this case, the Native Americans tricked the white man, as the Canarsie Indians sold land not even connected to Manhattan Island, and Manhattan Island was inhabited by Manhattan Indians, to whom the Dutch had to pay a second time for the land. Land swindles grew as America expanded west.

The advent of business organizations created new opportunities for fraud. The earliest corporations were formed in seventeenth-century Europe. Nations chartered new corporations and gave them public missions in exchange for a legal right to exist, separation of ownership from management, and limited liability that protected shareholders from losses of the business entity. One such corporation, the Massachusetts Bay Company, was chartered by Charles I in 1628 and had a mission of colonizing the New World.

The first major corporate fraud is probably the fraud known as the South Sea Bubble. The South Sea Company was formed in 1711 with exclusive trading rights to Spanish South America. The company made its first trading voyage in 1717 and made little actual profit to offset the £10 million of government bonds it had assumed. South Sea then had to borrow £2 million more. Tension between England and Spain led to the capture of South Sea ships by Spain in 1718. In 1719, the company proposed a scheme by which it would take on the entire remaining national debt in Britain, over £30 million, using its own stock at 5 percent in exchange for government bonds lasting until 1727. Although the Bank of England offered also to assume the debt, Parliament approved the assumption of the debt by the South Sea Company. Its stock rose from £128 in January 1720 to £550 by the end of May that year, in a speculation frenzy.

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The company drove the price of the stock up through artificial means; largely taking the form of new subscriptions combined with the circulation of pro-trade-with-Spain stories designed to give the impression that the stock could only go higher. Not only did capital stay in England, but many Dutch investors bought South Sea stock, thus increasing the inflationary pressure.<sup>6</sup>

Other joint-stock companies then joined the market, usually making fraudulent claims about foreign ventures, and were nicknamed “bubbles.” In June 1720, the Bubble Act was passed, which required all joint-stock companies to have a royal charter. Partly because it had a royal charter, the South Sea Company shares rocketed to £890 in early June 1720. The price finally reached £1,000 in early August, and a sell-off that began in June began to accelerate. The sell-off was begun largely by directors themselves cashing in on huge stock profits. As the stock price began to decline, the company directors attempted to talk up and prop up the stock (e.g., having agents buy stock) but to no avail—the stockholders had lost confidence and a run started in September. By the end of the month, the stock price dropped to a low of £150.

With investors outraged, and as many of them were aristocrats, Parliament was recalled in December and an investigation began. As part of that investigation, an external auditor, Charles Snell, was hired to examine the books of the South Sea Company. This hiring was the first time in the history of accounting that an outside auditor was brought in to audit books, and marks the beginning of Chartered Accountants in England and thus the beginning of Certified Public Accountants (CPAs) and financial audits as we know them today. Thus CPAs owe their profession, at least to a large extent, *to a fraud*.

In 1721, Snell submitted his report. He uncovered widespread corruption and fraud among the directors in particular and among company officials and their friends at Westminster. Unfortunately, some of the key players had already fled the country with the incriminating records in their possession. Those who remained were examined and some estates were confiscated.

At about the same time, France was experiencing an almost identical fraud from a corporation originally known as the Mississippi Company that had exclusive trading rights to North America in the French-owned Mississippi River area. Using similar tactics of exaggerating the potential profits, the company owner, famous economist John Law, was able to cause a frenzied upward spiral of its stock prices, only to see it collapse after the Regent of Orleans dismissed him in 1720. The company sought bankruptcy protection in 1721. Like South Sea, it was a fraud perpetrated by the exaggerations of executive management.

In 1817, the *Meyer v. Sefton* case involved a bankrupt estate. Since the nature of the evidence was such it could not be examined in court, the judge allowed the expert witness who had examined the bankrupt's accounts to testify to his examination. Forensic accounting professor and author Dr. Larry Crumbley considers this accountant to be the first forensic accountant in history and the beginning of forensic accounting as a profession.

In 1920, Charles Ponzi planned to arbitrage postal coupons, buying them from Spain and selling them to the U.S. Postal Service, using foreign exchange rates as leverage to make a profit. In order to raise capital for the scheme, he promised outlandish returns to investors—50 percent in 90 days. Ponzi paid the first returns with the cash proceeds from those coming in later, then he personally took the proceeds from later entrants to the scheme. He was imprisoned for defrauding 40,000 people of \$15 million. To this day, that type of scheme is referred to as a Ponzi scheme.

In the 1920s, Samuel Insull was involved in a fraud scheme similar to the railroad and South Sea Bubble schemes, but it occurred in the electric utility business. Insull sold millions of dollars of common stock in electric utility companies to unwary investors. The stock was greatly overpriced in terms of the utilities' real assets. When the stock market collapsed in 1929, it was apparent that Insull's holding company was insolvent and had been for some time.

Some researchers, such as Dr. Dale Flesher and Dr. Tonya Flesher, have presented sound arguments that the Securities Act of 1933 and the Securities Exchange Act of 1934 are a direct result of the Ivar Kreuger ("Match king") fraud rather than the stock market crash of 1929. Kreuger & Toll, a multibillion-dollar conglomerate, was a huge fraud built on shell companies and *unaudited financial statements*. Kreuger & Toll securities were among the most widely held in the United States. When the company went under in 1932, after Kreuger had committed suicide, investors lost millions in the largest bankruptcy of its time. Therefore, the argument goes, the existence of these legislative acts requiring financial audits of all companies with listed securities and the Securities and Exchange Commission (SEC) is the result of a major financial fraud, and can be seen by comparing the tenets of the acts against the financial fraud perpetrated by Kreuger versus the stock market crash itself. The acts of 1933 and 1934 essentially created the demand for financial auditors and the CPA profession that exists to this day.

A major savings and loan scandal hit hard in the early 1980s, preceding the energy and telecommunication companies' frauds in the 1990s. The latter led the seeming explosion of fraud around the last half of the 1990s

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and the early 2000s. During this period, high-dollar frauds reached all types of industries. For example, Waste Management in trash services, Pharmor in pharmacy, Sunbeam in manufacturing, Enron in energy, WorldCom in telecommunications, Adelphia in media, Fannie Mae in government, and HealthSouth in health services all occurred during this time. Several of these frauds were among the *largest ever*, and they occurred during a short period of time.

Although the cost of the WorldCom fraud was far greater, the most notable fraud, as far as impact on the business community, is probably Enron. In 2001, Enron filed bankruptcy after disclosing major discrepancies in revenues and liabilities in its financial reports. The audit firm Arthur Andersen came to an end as a result of the ramifications of the Enron scandal by 2002. In 2002, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) due to that fraud and others, such as WorldCom. Perhaps nothing has brought more attention to fraud audits and forensic accounting than the Enron scandal and SOX.

More recently, the housing and real estate boom of the 2000s has led to increased fraud particularly in the area of mortgage fraud. While the impact of these frauds is not yet entirely clear, mortgage fraud losses for 2007 alone have been estimated to be at least \$800 million. SARs from financial institutions indicated an increase in mortgage fraud reporting. SARs increased 31 percent to 46,717 during fiscal year (FY) 2007. The total dollar loss attributed to mortgage fraud is unknown. However, 7 percent of SARs filed during FY 2007 indicated a specific dollar loss, which totaled more than \$813 million.<sup>7</sup> Various pieces of legislation have been passed in response, continuing the cycle of evolving frauds and attempts to control them.

Are all of these events merely historical flukes? Did media attention create them? Perhaps. Media attention may have created the original public awareness, but the frauds and corruption were there all the time, and there exists no real way of measuring or comparing them. Part of the problem during the period of time when such large frauds occurred was the mind-set of the regulators and auditors, which has since turned around completely. Claims by management and others are less likely to be accepted at face value, and the financial well-being of the general public is more of a concern to antifraud and audit professions. Suspicion fell on industries, professions, and various areas of government. The undivided attention of auditors, regulators, management, and employees then led to wholesale charges of fraud, theft, and corruption.

The fraud environment can be and often is viewed as a pendulum, swinging from one extreme to the other with little time in between at the

proper balancing point. After 2002, the pendulum was close to an extreme end, one that entailed ultraconservatism on the part of companies, and auditors as well, and the stiffest requirements and enforcement by regulators and legislators. After swinging toward a more balanced position, the recent economic crisis has moved the pendulum back toward the extreme of 2002. This cycle (pendulum swing) is a natural result of human nature, business cycles, and the nature of legislation and regulation. The cycle can certainly be influenced and controlled to some extent, but it will probably never cease.

Fraud auditing literature discloses a common theme: Fraud is endemic and pervasive in certain industries, locales, companies, and occupations at particular points in history. For example, railroad promoters in the 1870s raised more capital from less informed investors than ever before and the railroad industry had numerous frauds exposed. During the 1950s, more doctors were involved in more income tax frauds than ever before or since. Food franchisers, in the late 1960s, are another example of the fraud phenomenon. Some fast-food franchisers sold unwary small investors on untested restaurant concepts at overvalued prices. These half-baked concepts led to the bankruptcy of many of the franchisees. During the Watergate era of the early 1970s, politicians were involved in corruption and fraud against taxpayers, and corporations were involved in political and commercial bribery, leading to the Foreign Corrupt Practices Acts of 1977.

## THE FRAUD CYCLE

The fraud cycle essentially begins with the plans of the fraudster leading up to the committing of the fraud act. Once committed, the fraudster converts the asset to cash, if necessary, and conceals the fraud.

The existence of a fraud usually comes to light through (1) an allegation, complaint, or a rumor of fraud brought by a third party (a disgruntled supplier or a fellow employee); (2) an investigator's intuition or general suspicion that something is awry; (3) an exception from an expectation of a person senior to the suspect (an unacceptable condition, profits, sales, costs, assets, or liabilities are too low or too high); (4) the accidental discovery that something is missing—cash, property, reports, files, documents, or data; (5) results from an audit; or (6) results of controls, especially antifraud controls. Based on the statistics from the ACFE's RTTNs, an average of about 60 percent of all frauds reported were discovered either by a tip or accident, indicating the need for

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more effective proactive detection methods such as internal controls and internal audits.

A fraud investigation is of necessity based on legal factors, because any fraud may end up in a court of law. The immediate facts to determine are whether a fraud has occurred and whether there is: (1) a criminal law, (2) an apparent breach of that law, (3) a perpetrator, and (4) a victim. The six basic steps in the fraud investigation are:

1. Acquire all available details and documents relating to the allegation.
2. Assess the allegation against the available documentation.
3. Assess the corporate environment relative to the person in question.
4. Ask whether a theory of fraud can be developed at this stage. Is there motive and opportunity?
5. Determine whether the available evidence makes sense. Does it meet the test of business reality?
6. Communicate with appropriate parties on the details and status of the fraud.

After performing these steps, two possibilities exist. Either one has identified the fraudster and knows who she is, or one has not. If not, more investigation is necessary. But if one does identify the fraudster, the process becomes critical to what is no longer an investigation, rather a pursuit of legal action.

Evidence gathered may consist of the testimony of witnesses, documents, items (means and instruments, or fruits of the crime), and possibly the confession of the perpetrator. Experienced fraud investigators know what evidence is needed to prove the crime and how to attain that evidence. Typically, interviewing the alleged, or known, fraudster is done only after competent and sufficient data have been gathered, assessed, and reasoned. If prosecution of a civil or criminal charge is sought, evidence must be presented in court—which is where the expert witness skill of a forensic accountant or fraud auditor is valuable. The court, trier of fact, then resolves the charge of fraud ending the fraud cycle. A successful prosecution needs someone who can explain, in layperson's terms, the records, data, documents, financial information, and files supporting the prosecutor's position.

This book provides readers with insight into each of these phases of the fraud life cycle. It also delves into the mind and behavior patterns of fraud perpetrators, their schemes, and the evidence they leave behind—from which their crimes can be reconstructed. Every fraud has its own unique wrinkles. All thieves do not



think alike. They tend to be opportunists. Given a set of circumstances that allow them to steal, they take the easiest way, usually weighing risks and rewards carefully. Culprits usually leave trails and sometimes make mistakes. Auditors must learn to look for these signs, or red flags, as they will be referred to in this book. While each fraud is different in some ways, they all have some similarities.

## REVIEW OF TECHNICAL LITERATURE

The technical literature begins with criminal and regulatory statutes involving business. For example, such literature includes the Sherman Antitrust Act (1890), the Internal Revenue Act (1913), the Securities Act of 1933 and Securities Exchange Act of 1934, Foreign Corrupt Practices Act (1977), Financial Fraud Detection and Disclosure Act (1986), Health Insurance Portability and Accountability Act of 1996 (HIPAA), Gramm-Leach-Bliley Act of 1999 (GLBA), and of course the Sarbanes-Oxley Act (SOX) (2002). Other applicable laws are related to mail fraud, fraud by wire, and the Federal Trade Commission (FTC). Federal laws that have contributed to the growth of fraud auditing include the Labor-Management Reporting and Disclosure Act, the Welfare-Pension Fund Act, and Employee Retirement Income Security Act (ERISA).

The savings and loans scandals of the early 1980s led to the National Commission on Fraudulent Financial Reporting (commonly known as the Treadway Commission, named after the chair of the Commission), which carried on its work as the Committee of Sponsoring Organizations (COSO), which is still functioning today. According to Treadway Commission findings, the most effective way to prevent financial scandals, such as the savings and loan ones, is for companies to have a strong set of internal controls. The model developed by the group has come to be known as the COSO Model of Internal Controls. It focuses on five key areas of internal controls:

1. Risk assessment
2. Control environment
3. Information and communication
4. Monitoring
5. Control activities

In 1992, the American Institute of Certified Public Accountants (AICPA) adopted the COSO Model as Statement on Auditing Standards (SAS) No. 78,

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*Consideration of Internal Control in a Financial Statement Audit.* The COSO Report was becoming a widely accepted framework for evaluating internal controls, and its acceptance and use was expected to grow. As a result, SAS No. 55 was amended to incorporate the COSO Report framework to provide useful guidance to financial auditors.<sup>8</sup>

In the late 1990s and early 2000s, a strong global economy met an increase in fraud in public companies and a lack of effective oversight. The result was a serious shock to the economy and to society as a whole. Public concern over fraud, in general, erupted to new and seemingly endless heights. Although concern over fraud has decreased some (a natural pendulum effect), the mentality toward fraud has clearly changed and for the better. Another positive result is that these large scandalous frauds have created a greater awareness of the need to further develop the discipline of fraud auditing. However, billions of dollars were lost, creating a serious “black eye” for the financial audit profession, and a wave of legislation resulted.

The latest round of legislation passed in the fight against fraud includes SOX, GLBA, and HIPAA. In the current environment, there is an extremely heightened expectation for businesses, auditors, investigators, and regulators to stop fraud. In order to control fraud, the response spurred by legislation must equal or exceed the energy exerted by fraudsters, which appears to have pervasively infiltrated society.

SOX in particular has greatly affected the awareness of and attention to fraud. The AICPA’s SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, codified and complemented many of the tenets of SOX, or best practices in antifraud. The Public Company Accounting Oversight Board (PCAOB), created by SOX and responsible for overseeing standards and enforcement, is setting its own standards affecting internal controls and fraud audits. The bottom line is, management of public companies has to accept responsibility for fraud per SOX and financial auditors have to be active in detecting fraud to comply with SAS No. 99.

SAS No. 99 has two basic requirements for financial statement audits. One is for auditors to exercise *professional skepticism*; that is, auditors are to be constantly mindful of the potential for fraud. The other is that fraud assessment must be included in audit steps from planning to reporting findings. SAS No. 99 emphasizes that evaluating audit evidence and adjusting the audit is a continual process. The audit team must identify, assess, and respond to fraud risks. Subsequently, the audit team must evaluate the findings of the audit tests and report to an appropriate level of management (usually the audit committee). Documentation must exist for all of these audit steps.

Section 404 of SOX requires management to evaluate the effectiveness of internal controls over financial reporting and to report on their evaluation in the annual report. This section also forces management to state their responsibility for internal controls. The internal control evaluation report and certain financial reports have to be signed by the chief executive officer (CEO) and chief financial officer (CFO), providing a legally enforceable claim. Management's internal controls must be evaluated by the financial (external) auditors who opine on that evaluation.

SOX also brought about these changes:

- More independent boards of directors (especially the audit committee)
- Increased involvement of the audit committee (especially oversight of management and antifraud programs)
- More financial expertise on the audit committee
- More independent reporting lines (external and internal auditors often report directly to the audit committee)

PCAOB Audit Standards No. 5 (AS 5) and No. 3 (AS 3) both address fraud. PCAOB guidance is applicable to issuers, or public companies, and AICPA guidance (SAS) is applicable to nonissuers, or private companies and issuers. AS 5 adopts many SAS 99 requirements. As part of that adoption, AS 5 (via SAS 99) notes the audit of internal control and the financial statement audit are connected, should be risk-based, and requires the nature, timing, and extent of financial statement audit procedures to be adjusted according to the results of the internal control audit. Results here certainly include any findings regarding fraud. AS 5 references the COSO Internal Control model with regard to managing fraud risk.

SOX, SAS No. 99, and AS 5 contain more details than can be summarized here, but these regulations and technical standards have stimulated similar legislation and standards abroad. Yet the need for fraud-auditing talents is not related solely to compliance with new governmental regulations.

## FORENSIC ACCOUNTANT AND AUDITS

It is important to define the term *forensic accountant* to ensure readers understand concepts and narratives throughout the book. One of the key points to understand about forensic accountants is the difference and roles of financial audits versus fraud audits. This section will discuss some of the issues and differences.

## Forensic Accounting Defined

In this book, the term *forensic accounting* refers to the comprehensive view of fraud investigation. It includes preventing frauds and analyzing antifraud controls. Forensic accounting would include the audit of accounting records in search for evidence of fraud; a fraud audit. A fraud investigation to prove or disprove a fraud would be part of forensic accounting. It also includes the gathering of nonfinancial information, such as interviews of all related parties to a fraud, when applicable. Forensic accounting includes writing a report to management or court. Serving as an expert witness and litigation support are part of forensic accounting.

Although relatively new to the accounting profession, the role of a forensic expert in other professions has been in place for some time. *Webster's Dictionary* defines the word *forensic* as “belonging to, used in, or suitable to courts of judicature or to public discussions and debate.” Accordingly, the term *forensic* in the accounting profession deals with the relation and application of financial facts to legal problems. Forensic accounting evidence, therefore, is oriented to a court of law.

## Financial Auditors, Fraud Auditors, and Forensic Accountants

In the lexicon of accounting, terms such as *fraud auditing*, *forensic accounting*, *fraud examination*, *fraud investigation*, *investigative accounting*, *litigation support*, and *valuation analysis* are not clearly defined. Some distinctions apply between fraud auditing and forensic accounting. Fraud auditing involves a specialized approach and methodology to discern fraud; that is, the auditor is looking for evidence of fraud. The purpose is to prove or disprove a fraud exists. Historically, forensic accountants, however, have been called in after evidence or suspicion of fraud has surfaced through an allegation, complaint, or discovery.

Forensic accountants are experienced, trained, and knowledgeable in all the different processes of fraud investigation including: how to interview people (especially the suspect) effectively, how to write effective reports for clients and courts, how to provide expert testimony in court, and rules of evidence. The ACFE refers to this definition of forensic accounting as *fraud examination*. In recent years, the broadest of these terms in the antifraud profession is *forensic accounting*, which typically refers to the incorporation of all the terms involved with investigation, including fraud auditing; that is, fraud auditing is a subset of forensic accounting.

Fraud investigation usually encompasses about the same thing as a fraud audit except investigation typically involves a lot more nonfinancial evidence, such as testimony from interviews, than a fraud audit. So fraud investigation includes fraud audit but goes beyond it in gathering non-financial forensic evidence.

Litigation support refers to a forensic accountant assisting attorneys in prosecuting or defending a case in the legal system. That support can take on a variety of skills but ultimately is intended to conclude with the forensic accountant offering an opinion in a court of law as an expert witness on whether a fraud occurred.

Valuation is a cottage industry of its own that overlaps with fraud. Especially in cases of litigation or insurance investigations, a forensic accountant or equivalent (Accredited in Business Valuation [ABV], Certified Valuation Analyst [CVA]) has to establish a value on the loss associated with a fraudulent event, whether it is a spouse trying to hide assets in a divorce case, or a customer claiming exorbitant losses in an insurance claim, or a victim entity suffering from a bad merger/acquisition that ended in a bankruptcy of the subsidiary.

*Financial auditing* is a wholly different term that needs to be distinguished from forensic accounting and fraud auditing. Financial auditing typically refers to the process of evaluating compliance of financial information with regulatory standards, usually for public companies, by an external, independent entity. The well-publicized SOX incorporates concepts and procedures to deter and to catch fraud in audits of internal controls over financial reporting. However, the focus of financial audits and financial reporting ultimately is concerned with providing *reasonable* assurance that a *material* misstatement to financial statements has not occurred, regardless of the reason.

### *Financial Auditors*

The term *financial auditor* broadly applies to any auditor of financial information or the financial reporting process. The largest classification of financial auditors is those who work for public accounting firms and perform audits of financial statements for public companies. This classification is the most commonly used in this book when referring to financial auditors.

Financial auditors have expertise in their knowledge of accounting and financial reporting (such as in generally accepted accounting principles [GAAP], PCAOB standards, or International Financial Reporting Standards [IFRS]), auditing (generally accepted audit standards [GAAS]), and how those

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standards apply to business transactions. As expressed in the GAAS literature, the most important financial auditing attributes are independence, objectivity, and professional skepticism.

Financial auditors traditionally have been seen as, and to an extent have been, numbers oriented, and their processes have been driven by the audit trail. The financial audit procedures are designed to detect material misstatements, and thus financial auditors focus on misstatements that singularly or in the aggregate are large enough to be material. Fraud auditors and forensic accountants are not constrained by materiality. The discipline of financial auditing has been thought to be almost a checklist of items to complete. In reality, judgment is crucial in financial auditing and has progressively increased in the direction of more dependence on auditor judgment. SOX requirements involve auditor judgment to a large degree; auditors are to understand processes significant to financial reporting and to evaluate management's controls over those processes. Additionally, auditors are to consider environmental, including soft, intangible, factors in that evaluation.

### *Fraud Auditors*

Fraud auditors are generally accountants or auditors who, by virtue of their attitudes, attributes, skills, knowledge, and experience, are experts at detecting and documenting frauds in books of records of accounting and financial transactions and events. Their particular attitudes include these beliefs:

- Fraud is possible even in accounting systems that have tight controls.
- The visible part of a transaction fraud may involve a small amount of money, but the invisible portion can be substantial.
- Red flags of fraud are discernible if one looks long enough and deep enough.
- Fraud perpetrators can come from any level of management or society.

The skills fraud auditors require include all of those that are required of financial auditors, plus the knowledge of how to gather evidence of and document fraud losses for criminal, civil, contractual, and insurance purposes; how to interview third-party witnesses; and how to testify as an expert witness.

Fraud auditors must know what a fraud is from a legal and audit perspective, an environmental perspective, a perpetrator's perspective, and a cultural perspective. They also need both general and specific kinds of experience. They should have a fair amount of experience in general

auditing and fraud auditing, but should have industry-specific experience as well (e.g., banking; insurance; construction; and manufacturing, distribution, and retailing).

Fraud auditing is creating an environment that encourages the detection and prevention of frauds in commercial transactions. In the broadest sense, it is an awareness of many components of fraud, such as the human element, organizational behavior, knowledge of fraud, evidence and standards of proof, an awareness of the potentiality for fraud, and an appreciation of the red flags. Some of the functions of a fraud auditor follow.

In short, fraud auditing is the process of detecting, preventing, and correcting fraudulent activities. While completely eliminating fraud is the goal, it is simply not feasible. The concept of reasonableness is applicable here, and this concept is often associated with the fraud-related fields of financial accounting and auditing. Fraud auditors should be able to thwart a reasonably preventable fraud.

Accounting-type frauds are usually accompanied by the modification, alteration, destruction, or counterfeiting of accounting evidence. But accounting records can be either intentionally or accidentally modified, altered, or destroyed, by human error or omission. The first objective for the fraud auditor, then, is to determine whether a discrepancy in accounting records is attributable to human error. If it is, there may be no actual fraud. If the discrepancy (missing records, destroyed records, modified records, counterfeit records, errors, omissions) cannot be attributed to accidental or human error, further investigation should follow at an appropriate level.

### *Forensic Accountants*

Forensic accountants may appear on the crime scene a little later than fraud auditors, but their major contribution is in translating complex financial transactions and numerical data into terms that ordinary laypersons can understand. That is necessary because if the fraud comes to trial, the jury will be made up of ordinary laypersons. Areas of expertise of forensic accountants are not only in accounting and auditing but in criminal investigation, interviewing, report writing, and testifying as expert witnesses. They must be excellent communicators and professional in demeanor.

The involvement of the forensic accountant is almost always reactive; this distinguishes forensic accountants from fraud auditors, who tend to be actively involved in prevention and detection in a corporate or regulatory environment. Forensic accountants are trained to react to complaints arising

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in criminal matters, statements of claim arising in civil litigation, and rumors and inquiries arising in corporate investigations. The investigative findings of the forensic accountant will impact an individual and/or a company in terms of their freedom or a financial award or loss. The ACFE refers to this person as a fraud examiner.

The forensic accountant draws on various resources to obtain relevant financial evidence and to interpret and present this evidence in a manner that will assist both parties. Ideally, forensic accounting should allow two parties to more quickly and efficiently resolve the complaint, statement of claim, rumor, or inquiry, or at least reduce the financial element as an area of ongoing debate. Objectivity and independence of the forensic auditor are paramount for these purposes.

### Differences among the Three

Forensic accountants, fraud auditors, and investigative auditors measure financial transactions in relation to various other authorities, such as the Criminal Code, an insurance contract, institutional policies, or other guidelines for conduct or reporting. The accountant/auditor prepares the report rather than the client or subject and does not include an opinion on the findings. In the investigation, one does not reject evidence as being immaterial; indeed, the smallest item can be the largest clue to the truth.

Fraud auditors, forensic accountants, and/or fraud investigators (i.e., all professionals involved with forensic accounting) put things together rather than taking them apart, as is the case in classic financial auditing or the modern method of systems analysis. The process of forensic accounting is also sometimes more intuitive than deductive, although both intuition and deduction play important parts. Financial auditing is more procedural in many regards and is not intended to work as effectively in detecting frauds as the tenets of fraud auditing and forensic accounting.

When a questionnaire was circulated among the staff members of Peat Marwick Lindquist Holmes, a Toronto-based firm of chartered accountants responsible for the forensic and investigative accounting practice, responses were insightful and should be of interest to the reader.

**Q1:** *How would you distinguish forensic accounting, fraud auditing, and investigative auditing from financial auditing?*

**A.** The distinction is related to one's goals. Financial auditing attempts to enable the auditor to render an opinion as to whether a set of



transactions is presented fairly in accordance with GAAP. The financial statements upon which the opinion is rendered are always the representations of management. The auditor is primarily concerned with qualitative values (hence the concept of materiality comes into play) and generally is not concerned about whether the financial statements communicate the policies, intentions, or goals of management.

- B.** *Forensic accounting* is a general term used to describe any financial investigation that can result in a legal consequence. Fraud auditing is a specialized discipline within forensic accounting, which investigates a particular criminal activity, namely fraud. Investigative auditing involves reviewing financial documentation for a specific purpose, which could relate to litigation support and insurance claims as well as criminal matters.
- C.** The objective of financial auditing is to provide the auditor with a degree of assurance in giving an opinion with respect to a company's financial statements. The materiality level of an investigative auditing engagement is much lower and more focused than that of the normal financial auditing engagement.

**Q2:** *How would you define what you do as a forensic accountant?*

- A.** I think of myself as one who seeks out the truth.
- B.** I would define my forensic accounting responsibilities as follows: (1) Investigation and analysis of financial documentation; (2) communication of the findings from my investigation in the form of a report, accounting schedule, and document briefs; and (3) coordination of and assistance in further investigation, including the possibility of appearing in court as an expert witness.
- C.** My role is that of an objective observer or expert. The final report that is issued as a result of my work will be used to negotiate some sort of settlement, be it financial or be it imprisonment. My role as a forensic accountant extends beyond the particular financial circumstances and seems to be one of an objective individual who provides the buffer between, in civil instances, the client and counsel, and, in criminal instances, the investigator and the prosecutor. Therefore, I am considered an integral member of the team of professionals assigned to any given case. Related to the specific work that I do, it has been described to me, and I agree, that the makeup of a given forensic accountant is one-third business person, one-third investigator, and one-third accountant.

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**Q3:** *What qualities of mind and/or body should a forensic accountant possess?*

- A.** Creativity: the ability to step out of what would otherwise be a normal business situation and consider alternative interpretations that might not necessarily make business sense; curiosity: the desire to find out what has taken place in a given set of circumstances; perseverance: the ability to push forward even when the circumstances don't appear to substantiate the particular instance being investigated or when the documentation is very onerous and presents a needle-in-a-haystack scenario; common sense: the ability to maintain a "real-world" perspective; business sense: the ability to understand how businesses actually operate, not how business transactions are recorded; confidence: the ability to believe both in yourself and in your findings so that you can persevere when faced with cross-examination.
- B.** As with any other pursuit, a healthy mind in a healthy body is a solid foundation. Beyond that, one should have generous proportions of common sense, inquisitiveness, skepticism, and an ability to avoid the natural tendency to prejudice—that is, to be fair and independent. In addition, because forensic work ultimately can lead to court appearances, good posture, grooming, vocal projection, and stamina can all be valuable attributes.
- C.** The foremost quality a forensic accountant requires is independence, because a forensic accountant is often forced to balance conflicting opinions about the same piece of documentation. The second major quality is an intense sense of curiosity coupled with a sense of order—a desire to put the puzzle back together.
- D.** Common sense/street smarts; sensitivity/understanding of human behavior; analytical; logical/clear; ability to simplify complexities and delete jargon; not be prone to lose the forest for the trees; ability to identify and assess alternative explanations and interpretations; ability to quickly assess cost-benefit of pursuing alternative avenues of investigation and reporting contents/formats.
- E.** The forensic accountant needs to be calm, cool, and collected; have good business judgment; and have a mind that can deal logically with esoteric issues and precise matters. A forensic accountant involved in litigation must be physically fit to withstand the long days and long nights of investigation and preparation for trial and the trial itself. Forensic accountants need to have a pleasant appearance and demeanor so that they will not be offensive when in the witness box.

- Q4:** *What skills are most important to the successful practice of forensic accounting?*
- A.** Solid technical accounting and financial skills—the basis of your “expertise”; ability to quickly prioritize issues and map out a “game plan”—good judgment; ability to communicate well—both verbally and in writing—is necessary to obtaining information, directing your staff, presenting your findings, and achieving your desired results. Even the best-planned and executed assignment can fail if you are unable to clearly and concisely present your findings.
  - B.** A forensic accountant needs to be precise, pay attention to detail, and be a broad thinker; that is, not suffer from tunnel vision.
  - C.** When looking at a given forensic accounting engagement, there are two major areas that come to mind in the completion of a given case. First, there is the investigative aspect, and second, the communication aspect. I feel that investigative skills would include areas such as the ability to assimilate large volumes of information, general organization and administrative skills, use the microcomputer or understand the abilities of the microcomputer, and interpersonal skills. Communication skills would include the ability to write a comprehensive report understandably.
  - D.** Communications skills: oral/written; interpersonal skills; listening skills; ability to synthesize/integrate; ability to identify/prioritize objectives/issues.

### **Financial Audit versus Fraud Audit**

Many in the public, and some in the U.S. Congress, have questioned why financial auditors do not detect more fraud. The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor’s audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the GAAS of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors’ reliance on examining the audit trail versus examining the events and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

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There are some basic differences today between the procedures of fraud auditors and those of financial auditors. Fraud auditors look behind and beyond the transactions and audit trail to focus on the substance of the transactions instead. The fraud auditor doesn't question how the accounting system and internal controls stack up against applicable standards but rather:

- Where are the weakest links in this system's chain of controls?
- What deviations from conventional good accounting practices are possible in this system?
- How are off-line transactions handled, and who can authorize such transactions?
- What would be the simplest way to compromise this system?
- What control features in this system can be bypassed by higher authorities?
- What is the nature of the work environment?

Another difference is the current status of technical guidance combined with research on frauds. Frauds can be divided into three main categories: (1) financial frauds, (2) asset misappropriations, and (3) corruption (ACFE fraud tree, discussed in Chapters 2 and 3). Financial frauds are typically perpetrated by executive management and average millions of dollars in losses. According to a recent KPMG *Fraud Survey*, that average is about \$258 million. Generally speaking, therefore, financial frauds are likely to be material, and thus financial audit procedures have the potential to detect them—because they would be a material misstatement, due to a material fraud. However, those who might be responsible for fraud audits internal to the firm could be constrained or thwarted in detecting the fraud because executives are in a position to hide the fraud or misdirect fraud auditors' efforts. Cynthia Cooper argues that at WorldCom she was thwarted from doing her job as internal auditor, but she eventually did uncover the financial fraud being perpetrated there.

## FORENSIC ACCOUNTANTS

The forensic accountant has skills, abilities, and knowledge related to the fraud cycle, including legal resolution. Because of the scope of fraud, the fact that fraud occurs in a lot of different arenas, there are a lot of different groups who could benefit from the services of a forensic accountant.

## Who Needs Forensic Accountants?

The increased business complexities in a litigious environment have enhanced the need for the forensic accounting discipline. It is possible to summarize the range of application into the following general areas:

- *Corporate investigations.* Companies react to concerns that arise through a number of sources that might suggest possible wrongdoing initiated from within and without the corporate environment. From the anonymous phone call or e-mail from disgruntled employees and third parties, these problems must be addressed quickly and effectively to permit the company to continue to pursue its objectives. More specifically, the forensic accountant assists in addressing allegations ranging from kickbacks and wrongful dismissals to internal situations involving allegations of management or employee wrongdoing. At times, a forensic accountant can meet with those persons affected by the allegations, rumors, or inquiries; they may view the accountant as an independent and objective party, and thus be more willing to engage in discussion.
- *Litigation support.* Litigation support includes assisting counsel in investigating and assessing the integrity and amount relating to such areas as loss of profits, construction claims, product liability, shareholder disputes, bankruptcies, and breach of contract. Obviously, litigation support is initiated by an attorney responding to some kind of legal action, whether criminal or civil.
- *Criminal matters.* Efforts to prevent white-collar crime have consistently used accountants and auditors in attempts to sort out, assess, and report on financial transactions related to allegations against individuals and companies in a variety of situations such as arson, scams, fraud (e.g., kickbacks or embezzlement), vendor frauds, customer frauds, investment scams, and stock market manipulations. In criminal matters, accountants and auditors as expert witnesses are increasingly important in court cases.
- *Insurance claims.* The preparation and assessment of insurance claims on behalf of the insured and insurers may require the assistance of a forensic accountant to assess both the integrity and the quantum of a claim. The more significant areas relate to the calculation of loss arising from business interruption, fidelity bond, and personal injury matters. Whereas certain of these cases require financial projections, many need historical analysis and other accounting and auditing-oriented services.

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- *Government/Regulation/Compliance.* Forensic accountants can assist entities to achieve regulatory and contractual compliance by ensuring that companies follow the appropriate legislation, law, or contract terms. Grant and subsidy investigations and public inquiries form a part of this service to government.

### **Forensic Accountant: Required Knowledge, Skills, and Abilities**

Many of the aspects of forensic accounting fall outside the traditional education, training, and experience of auditors and accountants. The following skills, abilities, and/or knowledge are necessary to serve as an effective forensic accountant:

- *Ability to identify frauds with minimal initial information.* Many times, the fraud investigation begins with minimal knowledge of the specifics of a potential fraud. The forensic accountant needs to be able to identify the possible scheme (i.e., fraud theory approach), the possible manner it was perpetrated, and potentially effective procedures to prove or disprove the potential fraud (i.e., the “theory”).
- *Interviewing.* Throughout the course of seeking evidence and information, the forensic accountant becomes involved in interviewing. For the forensic accountant, this function is another art to master. There are many things about interviewing, including what is the best order in which to interview parties of interest, that the forensic accountant must know. Most important, the forensic accountant must be prepared to handle a confession in such a way that the process ensures the evidence is admissible in a court of law.
- *Mind-set.* One of the critical success factors of forensic accountants, and one of the hardest to define or measure, is mind-set. A successful forensic accountant has a certain mind-set that includes several abilities. He or she is able to think like a crook. This attribute is basically counter to the average auditor who has lived a life with integrity and believes strongly in honesty. The successful forensic accountant knows almost instinctively that something “does not pass the smell test.” He or she is able to sense the anomaly sometimes before actually knowing the nature of the anomaly. This person has a healthy skepticism at all times, neither fully trusting people nor fully distrusting them. They have a natural tendency to question the substance behind transactions, documents, and testimony

(written or oral) that others do not have. They also know, and have, the following mind-set factors:

- Fraud can be detected as well as discovered by accident or tip.<sup>9</sup>
- Financial audit methodologies and techniques are not really designed to detect fraud but rather designed to detect material financial misstatements.
- Fraud detection is more of an art than a science. It requires innovative and creative thinking as well as the rigors of science.
- Determination, persistence, and self-confidence are more important attributes for a fraud auditor than intelligence.
- Logic and problem-solving and detective skills are critical success factors for fraud auditors and forensic accountants.
- *Knowledge of evidence.* The forensic accountant must understand what constitutes evidence, the meaning of “best” and “primary” evidence, and the form that various accounting summaries can take to consolidate the financial evidence in a way that is acceptable to the courts. It is imperative that a forensic accountant understand the rules of evidence in court and how to conduct the investigation from the beginning as if all evidence will make it to a court of law. If these rules are ignored, evidence could be compromised and found inadmissible if it does get to court.
- *Presentation of findings.* The forensic accountant must have the ability to clearly communicate the findings resulting from the investigation in a fashion understandable to the layperson. The presentation can be oral or written and can include the appropriate demonstrative aids. The role of forensic accountants in the witness box is the final test of the findings in a public forum. By its nature, however, accounting and financial information is difficult for the average person to comprehend. Therefore, the forensic accountant as an expert witness must have above-average communication skills in distilling financial information in a manner that the average citizen can understand, comprehend, and assess to reach a sound conclusion.
- *Knowledge of investigative techniques.* When the issues have been identified, it is imperative that further information and documentation be acquired to obtain further evidence to assist in either supporting or refuting the allegation or claim. It is a question of knowing not only where the relevant financial documentation exists but also the intricacies of GAAP, financial statement disclosure, and systems of internal control, and being aware of the human element involved in frauds.

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- *Investigative skills.* Forensic accountants usually apply investigative skills at the appropriate time during the course of their investigations. For example, in dealing with criminal matters, the primary concern is to develop evidence around motive, opportunity, and benefit. Of equal concern is that the benefit of doubt is given to the other side to ensure that proper interpretations are given to the transactions. Other concerns, such as the question of method of operation and the issue of economic risk, must also be addressed.

Similarly, investigative skills are needed in litigation support. The forensic accountant must ensure that: a proper foundation exists for the calculation of future lost profits; all assumptions incorporated into the work product are recognized and identified; he understands his limitations as an expert; and the issue of mitigation of damages is considered.

- *Investigative mentality.* Along with their accounting knowledge, forensic accountants develop an investigative mentality that allows them to go beyond the bounds set out in either GAAP or GAAS. The following three tenets in forensic accounting are driven by the necessity to prove intent in court in order to prove there was a fraud. The investigative mentality develops in the search for best evidence, for competent and sufficient evidence, for forensic evidence. For example:
  - *Scope is not restricted as a result of materiality.* Often, especially in the early stages of a management/employee fraud, the transactions are small and accordingly are more easily conveyed to the court to show a pattern of conduct that is deceitful. As the dollar value of the transactions and their complexity increase, the ability to convey the essence of the transaction is hampered, and the forensic accountant's task is made more difficult.
  - For the most part, the *use of sampling* is not acceptable in establishing evidence.
  - A critical element of corporate investigations in particular is the assumption of integrity by management, both personal statements and its documentation of financial transactions and events.

The investigative mentality is best developed by continued experience as a forensic witness. It is through this process that the forensic accountant's eyes are opened, because counsel for the opposing side raises issues and possibilities the accountant may not have considered up to that point. Repeated experience as a forensic witness creates a greater awareness of what is relevant and must be considered, so the



expert witness can present financial evidence independently and objectively to reflect the reality of the situation.

- *Identification of financial issues.* When forensic accountants are presented with a situation generated by a complaint, allegation, rumor, inquiry, or statement of claim, it is important that they clearly identify the financial issues significant to the matter quickly. They base their decisions on experience and knowledge, and any resulting recommendations must reflect both common sense and business reality. For example, if documents are needed from a foreign jurisdiction, although the most obvious recommendation would be to obtain these records, it is usually not practical to do so. Other alternatives must be considered.
- *Interpretation of financial information.* It is unusual for a transaction or a series of events to have only one interpretation. The forensic accountant must be extremely conscious of a natural bias that can exist in the interpretation process. It is important that transactions be viewed from all aspects to ensure that the ultimate interpretation of the available information fits with common sense and the test of business reality. A proper interpretation of information can be assured only when one has looked behind and beyond the transaction in question without any scope limitations. In particular, a forensic accountant who is called as an expert witness must be aware of alternative accounting or financial formulas, rules, and interpretations.

## FRAUD AUDITORS

Just as forensic accountant services are needed by a variety of groups, fraud audits also have a number of groups who could potentially benefit from their services, although it is somewhat less in scope than forensic accountants. The scope is less because fraud audits involve only a limited phase of the fraud cycle.

### **Who Needs Fraud Auditors?**

The need for fraud-auditing talent is not related solely to compliance with new governmental regulations. In the private sector, fraud-auditing skills are also useful in most cases of financial crime, such as embezzlement; misrepresentations of financial facts; arson for profit; bankruptcy fraud; investment frauds of all manner and description; bank fraud; kickbacks and commercial bribery; computer frauds; electronic funds transfer (EFT) systems frauds; credit card

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frauds; and scams and shams by vendors, suppliers, contractors, and customers.

In the United States, the largest body of trained and experienced fraud auditors comes from government audit and investigative agencies like the Internal Revenue Service (IRS), FBI, Government Accounting Office (GAO), and the SEC. Police authorities on the state and local levels have few audit resources at their disposal; as a consequence, their ability to investigate certain white-collar crimes is limited. There is a need for fraud auditing in both public and private sectors of the economy.

Public accounting firms and other organizations in the private sector are developing fraud audit expertise. Although relatively few public accountants and internal auditors are specifically trained and experienced in this discipline, their numbers are rapidly increasing.

### **Fraud Auditor: Required Knowledge, Skills, and Abilities**

More broadly, fraud auditing focuses on creating an environment that encourages the detection, prevention, and correction of intended or executed fraud. The main thrust of this book is to provide auditors, investigators, and other persons in the fraud environment with the ability to establish and influence forces that effectively counter attempts at fraud. Ability comes from insight, knowledge, and experience in viewing fraud as an economic, social, and organizational phenomenon.

Fraud auditors should know the aspects of the common body of knowledge regarding fraud. That knowledge includes: fraud schemes, red flags and the ones associated with specific frauds, the fraud triangle, fraud research, emerging fraud issues, steps in a fraud investigation, legal aspects of fraud (especially evidence), fraud professional organizations, fraud certifications, behavioral characteristics of white-collar criminals, and so on. The fraud auditor, of course, needs to be able to apply that knowledge in the fraud environment.

The personal attributes of fraud auditors include self-confidence, persistence, commitment to honesty and fair play, creativity, curiosity, an instinct for what is out of place or what is out of balance, independence, objectivity, good posture and grooming (for courtroom testimony), clear communication, sensitivity to human behavior, common sense, and an ability to fit pieces of a puzzle together without force or contrivance.

Inevitably, accounting and investigative (legal) skills cross over and are inextricably tied together in the context of a forensic audit. Although auditors and investigators exhibit similar skills in some ways, when separated they

demonstrate different abilities. As for accounting skills, an effective fraud auditor should be able to do the following competently:

- Establish accounting, audit, and internal control (when, where, and how fraud is most likely to occur in books of account and in financial statements).
- Conduct a review of internal controls.
- Assess the strengths and weaknesses of those controls.
- Design scenarios of potential fraud losses based on identified weaknesses in internal controls.
- Know how to identify questionable and exceptional transactions (too high, too low, too often, too rare, too much, too little, odd times, odd places, odd people).
- Identify questionable and exceptional account balances and variations.
- Distinguish between simple human errors and omissions in entries and fraudulent entries (intentional error, such as recurring small errors versus unintentional random error and ignorance).
- Know how to follow the flow of documents that support transactions.
- Follow the flow of funds in and out of an organization's account.
- Search for underlying support documents for questionable transactions.
- Review such documents for peculiarities like fake billings, destruction of data, improper account classification, irregularities in financial data, and substitution of copies for original documents.

A couple of notes with regard to these skills should be made. One of these is the “toos” and the “odds” method for identifying possibly fraudulent transactions. Transactions are suspect if they are too high, too low, too often, too rare, too close, at odd times, in odd places, and so forth. A good example of the “too close” idea is the common check fraud perpetrated at a high dollar amount that bypasses the usually necessary high-level approval by paying the amount with multiple checks just under the threshold for (extra) approval. A mid-level accounts payable manager may be able to solely sign checks only for \$1,000 and under, but can get \$1,998 without additional approval with just two checks of \$999 each, just below the approval threshold.

Beyond these skills that also relate to investigation, fraud auditors should be reasonably able to:

- Verify compliance with regulatory, legal, and evidential matters (how to discern, detect, and document such frauds).

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- Gather and preserve evidence to corroborate asset losses, fraudulent transactions, and financial statements.
- Document and report a fraud loss for criminal, civil, or insurance claims.
- Be aware of management, administrative, and organizational policies, procedures, and practices.
- Review documents related to legal and general business functions.
- Test the organization's motivational and ethical climate.

The skills of a criminal investigator are in some respects similar to those of an auditor. An auditor and a detective both seek the truth: the auditor with respect to the proper accounting of business transactions and the detective/investigator with respect to the proper, legal behavior of citizens. Both should have inquisitive minds and challenge things that appear to be wrong, knowing that many times, the opposite of what one would logically expect is the logical place to start.

Auditing for fraud is as much of an intuitive process as it is a formal, analytic methodology. It is as much of an art as it is a science. As a consequence, it is difficult to teach and more difficult to learn. Skill depends on the right mind-set (thinking like a thief, probing for weaknesses) and practice. But it is not technique that one should master; rather, it is mental disposition: doggedness and persistence. One seeks relevant information without assumption, organizes it in some meaningful way, and then sees the pattern it creates. One goes behind and beyond those transactions to reconstruct what may have led to them and what has followed from them.

### *Investigative Intuition*

Laypersons call this gift investigative intuition. Investigators call it professional judgment—judgment derived from knowledge, education, training, acquired skills, and experience. No one is wholly born with it, although certainly some are born more capable and some learn better. Intuition is learned mainly by trial and error. It is not a formula, and it cannot actually be taught.

The hunch of an amateur may not be worth much, based as it is on naiveté. The hunch of a trained investigator is worth much more, because it is based on experience, knowledge, and training. Even when auditors or investigators say they have discovered a fraud in accounting records by accident, it may be no accident; their trained eyes and ears can discern the truth. Police detectives also attribute some of their investigative insights to accident, chance, or good luck. But there again, their breakthroughs are not simply random

events; they are brought about by their concentration and focus on the issue at hand. It is not black magic or fortuitous circumstances.

The authors would like to counter the feigned humility of some investigators and auditors by proposing that “accidental” discoveries of crimes by investigators and frauds by auditors usually are attributable not to pure chance but to know-how. Unfortunately, not all investigators or auditors have such know-how. The investigative mentality comes with age, training, self-discipline, experience, and a mind-set that understands that crime and fraud are possible in any environment, at any time, by anyone, *if the circumstances are ripe*.

### ***Applicable Laws and Regulations***

Fraud auditors should be familiar with applicable legislation, standards, and other requirements. That includes criminal and regulatory statutes involving business (see the “Review of Technical Literature” section in this chapter for details). These laws, together with the increase in fraud in public companies, waste and abuse in government contracting, and the current public concern over white-collar crime, create a greater need for further development of the discipline of fraud auditing.

### ***Thinking Like a Fraud Auditor: Mind-Set***

Investigating fraud requires the combined skills of a well-trained auditor and a criminal investigator. However, finding these skill sets in one person is rare. Part of the mission of this book is to better acquaint auditors with criminal-investigative rules, principles, techniques, and methods and to provide criminal investigators with some knowledge of accounting and auditing rules, principles, techniques, and methods. The result is, it is hoped, an ability to think more like a fraud auditor.

Financial auditors tend to use the inductive approach, whereas investigators tend to use the deductive approach. Fraud auditors may have to use both approaches in developing their investigative mentality.

Fraud involves so many variables in terms of fraud types, defrauder types, victim types, crime methods, techniques, tools, means, and instruments that any effort to unify them into a comprehensive theory of causation or solution seems impossible. This fact is why intuition, experience, and training are so vital to fraud auditing. Thinking like a fraud auditor means being perceptive, using inductive logic based on perception, and knowing how fraud plays into audits and criminal investigations.

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### *Setting the Tone*

Fraud auditors should set the tone and the standard, including demonstrating the highest standards of ethical conduct. This goal means that the fraud auditor within a company should have in place, and communicated to all employees, an effective corporate code of conduct, which should also include conflict-of-interest policy guidelines signed by employees to provide a clear understanding of the intent of management and the level of expectations.

### *Effective Corporate Governance*

In many ways, SOX is an attempt to mandate good corporate governance tenets, or best practices, for publicly-traded companies. Fraud auditors need to be familiar with best practices of corporate governance as they relate to fraud. Closely aligned to “tone at the top” is the need for fraud auditors to assist the board in ensuring the entity is reasonably vigilant regarding fraud detection and prevention. Of particular importance would be the audit committee of the board of directors having oversight of a strong antifraud program or set of programs. Therefore, fraud auditors should be able to contribute to an effective antifraud program as a part of overall corporate governance.

### *Principles of Fraud Audits*

Many principles of fraud audits should be understood by all auditors. They are:

- Fraud auditing is different from financial auditing. It is more a mind-set than a methodology.
- Fraud auditors have different approaches from financial auditors. Fraud auditors mostly focus on exceptions, oddities, accounting irregularities, and patterns of conduct. Financial auditors mostly focus on the audit trail and material misstatements.
- Fraud auditing is learned primarily from experience, not from audit textbooks or last year’s work papers. Learning to be a fraud auditor means learning to think like a thief: “Where are the weakest links in this chain of internal controls?” “How can I steal on my job and get away with it?”
- From an audit perspective, fraud is intentionally misrepresenting financial facts of a material nature. From a fraud-audit perspective, fraud is an intentional misrepresentation of material financial facts.
- Frauds are committed for economic, egocentric, ideological, emotional, and psychotic reasons. Of the five, the economic motive is the most common.

- Fraud tends to encompass a theory structured around motive, opportunity, and rationalization (the “fraud triangle”).
- Fraud in a computerized accounting environment can be committed at any state of processing—input, throughput, or output. Input frauds (entering false and fraudulent data) are the most common.
- The most common fraudulent schemes by lower-level employees involve disbursements (payables, payroll, and benefit and expense claims).
- Accounting-type frauds are caused more often by absence of controls than by loose controls.
- Fraud incidents may not be growing exponentially, but fraud losses are growing fairly rapidly (\$400 billion in 1996 to \$994 billion in 2008).<sup>10</sup>
- Accounting frauds are discovered more often by reactive measures than by proactive ones. (Tips and accidents make up over 65 percent of frauds detected.) Only about 10 percent of frauds are detected by financial auditors, and only about 23 percent of frauds are detected by internal controls, which is the highest of any proactive measures.
- Fraud prevention is a matter of adequate controls and a work environment that places a high value on personal honesty and fair dealing.

## KEYS TO EFFECTIVE FRAUD INVESTIGATION

Perhaps a brief overview of a fraud investigation is the best way to convey the principles of forensic accounting. In terms of organizational fraud, the objective is to determine whether a fraud has occurred or is occurring and to determine who the fraudster is. In litigation support, the objective is determined by the client.

*Predication* is necessary to initiate the fraud investigation. Predication is the set of circumstances that would lead the prudent, reasonable, and professionally trained individual to believe that a fraud has occurred, is occurring, or will occur. In litigation support, however, predication is a call from a lawyer.

If the specific fraud is not known, or if there is limited information on the fraud, then the next step would be the *fraud theory approach*. In this approach, the forensic accountant, probably in a brainstorming setting, would propose the most likely fraud scheme (if not previously known), and the manner in which that fraud scheme could have been perpetrated on the victim organization. This latter substep is often necessary even in litigation support. Obviously, the forensic accountant needs to be familiar with fraud schemes and red flags associated with each (see Chapters 3 and 4). The theory then serves as the basis for developing a fraud investigation plan.

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Using the theory, the forensic accountant develops a plan to gather sufficient and competent evidence (i.e., forensic evidence). This step is where the fraud auditor is particularly applicable (see Chapters 4 through 13 for various concepts in gathering evidence). In this step, an examination is made of accounting records, transactions, documents, and data (if applicable) to obtain sufficient evidence to prove or disprove that the fraud identified earlier has occurred. Issues of importance include custody of evidence and other legal matters (see Chapter 11).

It is important to note that the *last step* in the process of the investigation is to *approach the suspect*. That can happen intentionally and accidentally. The intentional approach should be easy enough to avoid, but the accidental requires some extra effort. When an auditor comes across an anomaly (document, accounting transaction, or other evidence of something that “should not be” or a red flag associated with known frauds, or a violation of internal controls), before approaching someone for an explanation, *first* she should ascertain the probability that the reason for the anomaly is *not fraud*. The reason for this caution is often when an auditor unwittingly has evidence of a fraud in hand, she goes to a party responsible for the fraud and asks for an explanation for the anomaly. At this point, the investigation at best has been severely hampered and at worst has been compromised for obtaining a confession or conviction in court.

For example, an internal auditor notices on performance reports that actual expenses are exactly twice the budget. That is classified, in our terminology, as an anomaly (“should not be”). The natural inclination is to go to the person responsible for authorizing checks in that business unit and ask for an explanation. However, if that person is using an authorized maker fraud scheme combined with forged endorsement, he could be cutting two checks for a single invoice—one for the vendor and one for the fraudster to forge an endorsement and convert to cash. If the auditor does approach that person, either he will come up with a viable excuse, or the auditor could unknowingly offer one. In a real case, the fraudster remained silent, and the auditor said, “You must have paid the vendor twice,” to which she replied, “Yes. That is what I did.” The fraudster then had the opportunity to replace the stolen funds without getting caught. Had the auditor assumed it could be fraud, then he would have had the opportunity to gather evidence to determine whether it was error or fraud, and possibly would have found the fraud. But by going to the fraudster, he gave her an undetectable exit strategy to the fraud. In other cases, fraudsters confronted by accident have suddenly retired, burned the business building (destroyed



accounting records), or done other things that frustrated any appropriate conclusion to the fraud.

After gathering accounting evidence, the forensic accountant will attempt to gather evidence from eyewitnesses, using interviews. This process goes from people the greatest distance from the fraud (not involved but possibly knowledgeable), to an ever-narrowing circle of people close to the fraud (firsthand knowledge), and, as said before, interview the suspect last. Care should be taken to make sure the suspect does not know a fraud investigation is under way until the forensic accountant is sure he/she has forensic evidence of a crime.

Finally, the forensic accountant writes up the findings in a report to the party who hired him. If the case goes to court, this report, or a similar one, may be necessary during the trial. But regardless, if the case goes to trial, the forensic accountant's work will have to be presented in an effective manner to the judge or jury (see Chapters 14–16 for more detailed steps). It is part of the forensic accountant's ethics to *never* make a claim of innocence or guilt on the part of a suspect. Much like Sergeant Joe Friday of the *Dragnet* series, "Just the facts ma'am" is key to any report or testimony by the forensic accountant.

## THE ANTIFRAUD PROFESSIONAL'S CAREER

There are several professional organizations that either focus on fraud and forensic accounting, or are key players in education, training, and identifying forensic accountants through certification. As in other areas of accounting and audit, certification is a key differentiator.

### **Certification**

The Association of Certified Fraud Examiners (ACFE) was founded in 1988 by Joe Wells and others. It was the dream of Donald Cressey and Edwin Sutherland, two pioneers in white-collar crime, which was made a reality by Wells. The ACFE is a global, professional organization dedicated to fighting fraud and white-collar crime, with over 30,000 members in over 100 countries. Since its inception, the ACFE has been a major resource for fraud information and training. The Certified Fraud Examiner (CFE) program is an internationally recognized accrediting process for individuals who possess the specialized skills required to detect, investigate, and deter fraud. The domains of

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the CFE exam include: criminology and ethics, financial transactions, fraud investigation, and legal elements of fraud. Some have said that the ACFE is the premier financial sleuthing organization in the world today.

The AICPA introduced the Certified in Financial Forensics (CFF) program in the fall of 2008. Like all other AICPA certifications, a person has to be a CPA in order to attain the CFF. While the CFF began as an experienced-based certification, the AICPA plans to go to an exam-based certification in the summer of 2010. The domains of the CFF body of knowledge (BOK) include: bankruptcy and insolvency, computer forensics, economic damages, family law, fraud investigation, litigation support, stakeholder disputes, and valuations. Obviously, the CPA designation is deemed a qualification in order to serve as an expert witness on fraud. The CFF adds to that value, and expands the CPA's knowledge to specific fraud-related knowledge.

Business valuation is a profession of its own, and plays a common role in the fraud profession. That service is needed in lawsuits for failed mergers and acquisitions (M&A) (where the acquired company goes bankrupt soon after the merger or acquisition), failed marriages (where one spouse suspects the other is hiding assets), and other fraud-related resolutions. The AICPA offers the ABV certification. The domains of the exam include: the engagement, professional and regulatory standards, qualitative and quantitative analysis, valuation analysis, and related topics. The National Association of Certified Valuation Analysts (NACVA) offers a similar certification, the CVA. The domains for the exam include: fundamentals-techniques-theory, applications and calculations of the income and asset approaches, case analysis, and special purpose valuations.

The Association of Certified Forensic Specialists (ACFS) offers the Certified Forensic Specialist (CFS) certification. This certification is experienced based.

Another antifraud organization is the American College of Forensic Examiners Institute (ACFEI). The ACFEI is an independent, scientific, and professional society that is multidisciplinary in its scope, covering a large number of forensic-related disciplines or areas including forensic accounting. The ACFEI's purpose is the continued advancement of forensic examination and consultation across the many professional fields of its membership. The ACFEI has elevated standards through education and training.

One of the ACFEI certifications is the Certified Forensic Accounting (Cr.FA). The role of the forensic accountant necessitates specialized training and skills that are not typically part of an accountant's formal education. Forensic accountants are professionals who use a unique blend of education and experience to apply accounting, auditing, and investigative skills to uncover

truth, form legal opinions, and assist in investigations. Forensic accountants may be involved in both litigation support (providing assistance on a given case, primarily related to the calculation or estimation of economic damages and related issues) and investigative accounting (looking into illegal activities). Thus the Cr.FA program provides advanced education and training to cover the wide range of skills, abilities, and knowledge necessary in forensic engagements. As of January 1, 2006, a person must be a CPA to acquire the Cr.FA certification.

### Training/Education

Until the Enron scandal, there were few young accountants in the field of fraud. Those in this specialized field tended to be experienced in financial auditing, either in public accounting or fraud auditing in government agencies, before they ventured into private practice. But beginning with 2000, training for fraud auditors and forensic accountants has changed. For instance, prior to 2000, there were very few courses in fraud, and no degree with 18 hours or more of fraud education. Now there are a few college degree programs in fraud auditing or forensic accounting, and the number of these courses or degrees is growing rapidly.

Also, many professional associations now provide fraud training. The ACFE offers many seminars and training, featuring its weeklong course known as fraud boot camp. The ACFEI provides continuing education and seminars specifically on fraud. The Institute of Internal Auditors (IIA) provides periodic specialized training and conferences on fraud auditing, as does the Information Systems Audit and Control Association (ISACA) and the AICPA. In fact, it is hard to find an accounting or auditing professional organization that does not offer training for fraud today.

Subjects that could be or should be covered by training for fraud auditors include:

- Legal process, criminology, rules of evidence
- Financial accounting
- Fraud schemes, including red flags and countermeasures
- Fraud principles, such as the fraud triangle and fraud tree (see Chapters 2 and 3)
- Profile, sociology, and psychology of the white-collar criminal
- Interviewing skills
- Roles of various auditors

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- Fraud in manual versus computerized accounting systems
- Preventing fraud, detecting fraud, and response to fraud
- Fraud risk assessment
- Internal controls, especially antifraud controls
- Tools and techniques for detecting fraud
- Testifying as an expert witness in accounting matters
- Deterring fraud in books of account—creating awareness of the risk of fraud, establishing personnel policies, ethical codes, and loss prevention programs, conducting audits

 **SUMMARY**

What can be learned from fraud statistics and news reports? First, fraud can happen anywhere. Second, fraud is pervasive and continues to grow in terms of losses and perhaps in frequency—no one knows how much fraud has gone undetected.

What can be learned from reviewing the history of fraud? First, that a certain percentage of humanity will always be drawn to white-collar crimes and fraud, just as a certain fraction of humanity is drawn to crime in general. There will always be fraudsters willing to take the risk in order to gain the ill-gotten gains of fraud. Second, financial statement frauds across history have been associated with stock prices throughout history. Last, fraudsters are sometimes quite intelligent, sometimes charming personalities, and sometimes just plain stupid.

The fraud cycle describes the necessary phases of resolving fraud, and the need to understand and incorporate legal factors in all aspects, all steps, in the fraud life cycle.

The technical literature related to forensic accounting describes the role of accountants and auditors, and their responsibilities related to fraud.

The forensic accountant has a relatively large scope of the fraud cycle in terms of role and responsibility. For example, it is the forensic accountant, generally speaking, who becomes the expert witness in the resolution stage of fraud. However, the fraud auditor's role is, generally speaking, limited to gathering evidence of a fraud, and primarily financial evidence. That being said, a fraud auditor may be required to serve as a fact witness or possibly an expert witness. But both of these roles require skills, knowledge, and abilities beyond the traditional financial auditor.

There are some keys to fraud investigation, many of which will be revealed in subsequent chapters. There is the requirement of predication before beginning an investigation, and the need to make sure no accusation is made during the investigation, written or oral. The fraud theory approach is an effective way to provide strategic direction to a fraud investigation. But perhaps the most important key to a successful investigation is to approach the suspect later in the investigation.

The antifraud profession has grown significantly over the last decade and there are a number of organizations that will support one's career in antifraud, a number of certifications available, and lots of training and education compared to decades past.

The following chapters will expand on many of these ideas hopefully to provide valuable information to those with responsibilities to prevent or detect fraud.



## NOTES

1. FBI Insurance Fraud Report, [www.fbi.gov/publications/fraud/insurance\\_fraud.htm](http://www.fbi.gov/publications/fraud/insurance_fraud.htm), last accessed September 11, 2009.
2. [www.fbi.gov/publications/fraud/mortgage\\_fraud07.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud07.htm), last accessed August 31, 2009.
3. FBI Mortgage Fraud Report "Year in Review," [www.fbi.gov/publications/fraud/mortgage\\_fraud08.htm#1](http://www.fbi.gov/publications/fraud/mortgage_fraud08.htm#1), last accessed September 11, 2009.
4. [www.nicb.org](http://www.nicb.org), last accessed September 11, 2009.
5. Some of the information in this section comes from Dr. Robert E. Jensen's web site at Trinity University, [www.trinity.edu/rjensen/415wp/AmericanHistoryOfFraud.htm](http://www.trinity.edu/rjensen/415wp/AmericanHistoryOfFraud.htm), last accessed January 13, 2006.
6. <http://myweb.dal.ca/dmoneil/bubble/bubble.html>, last accessed April 26, 2010.
7. [www.fbi.gov/publications/fraud/mortgage\\_fraud07.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud07.htm).
8. David R. Frazier and L. Scott Spradling, "The New SAS No. 78," *The CPA Journal*, May 1996.
9. According to the ACFE 2004 Report to the Nation, the number one method of detection is tip and the number three method is accident.
10. ACFE, RTTN, 1996, 2002, 2004, 2006, and 2008.

