# PART I

# Forensic Accounting and Fraud Overview

# CHAPTER 1

# Forensic Accounting

## What Is Forensic Accounting?

Ask any two practicing forensic accountants to define what forensic accounting is, and you are likely to get two different answers. Both may be accurate, and there likely will be some similarities within the responses, but still there is no one consistent answer recited by everyone who practices in this specialized area of accounting. The responses provided will depend largely on the background, experience, and areas of practice of each individual forensic accountant.

Forensic accounting definitions commonly refer to fraud, fraud prevention, and fraud investigations as the role of the forensic accountant. While those definitions are not necessarily inaccurate, they provide a definition of forensic accounting only within the specific context of fraud. Many books have even been written about forensic accounting that focus the writing on fraud schemes, preventing them as well as investigating them, and include a wealth of information relating to fraud. This is the case with *A Guide to Forensic Accounting Investigation* by Golden, Skalak, and Clayton. It is an excellent publication and one I rely heavily upon in my class as an adjunct professor at the University of Connecticut, but the issue is this—the book is titled *A Guide to Forensic Accounting Investigation* and not *A Guide to Fraud Investigation*. Fraud is only one context where the skills of forensic accounting can prove invaluable—there are many, many other contexts beyond fraud to which forensic accounting applies.

In searching the materials available, the following definition is found within *Forensic Accounting* by Hopwood, Leiner, and Young:

> *Forensic accounting is the application of investigative and analytical skills for the purpose of resolving financial issues in a manner that meets*

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*standards required by courts of law. Forensic accountants apply special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, research and investigative skills to collect, analyze and evaluate evidential matter and to interpret and communicate findings.*[1]

*Forensic Accounting and Fraud Examination* by Kranacher, Riley, and Wells defines financial forensics similarly, as follows:

*Financial forensics is the application of financial principles and theories to facts or hypotheses at issue in a legal dispute and consists of two primary functions:*

1. *Litigation advisory services, which recognizes the role of the financial forensic professional as an expert or consultant*
2. *Investigative services, which makes use of the financial forensic professional's skills and may or may not lead to courtroom testimony.*

*Financial forensics is the intersection of financial principles and the law and, therefore, applies the (1) technical skills of accounting, auditing, finance, quantitative methods, and certain areas of the law and research; (2) investigative skills for the collection, analysis, and evaluation of evidentiary matter; and (3) critical thinking to interpret and communicate the results of an investigation.*[2]

Perhaps Crumbley, Heitger, and Stevenson Smith in their book *Forensic and Investigative Accounting,* Second Edition, provide the clearest and most concise definition of forensic accounting: "Forensic accounting is the use of accounting for legal purposes."[3]

They continue in their initial discussions about forensics and accounting to include a much longer but equally understandable definition, as follows:

*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.*[4]

## Why Has Forensic Accounting Become the Buzz?

Forensic accounting is not a new specialized area of accounting. On the contrary, the skill set and activities encompassing forensic accounting have been around for quite a while, although it wasn't necessarily always called forensic accounting. As far back as 1554, an individual by the name of Hercules De Cordes, a schoolmaster and bookkeeper, testified on three occasions as an expert witness.[5] By the late 1800s, articles relating to fraud, investigations, and expert witnessing began to appear. The person credited for likely being the first to coin the phrase *forensic accounting* was Maurice E. Peloubet, a partner in the public accounting firm Pogson, Peloubet & Company in New York.[6]

Law enforcement agencies at the federal, state, and local levels historically have recruited and trained individuals to investigate financial matters, as have many other governmental and nongovernmental agencies and organizations. Recruiters continue today to appear on college campuses around the country seeking to attract accounting and finance graduates into the field of forensic accounting and fraud, and schools across the country and around the world have started offering courses and in limited cases undergraduate and graduate degrees specific to forensic accounting.

Certainly the opportunity to apply accounting and auditing knowledge, training, and experience to careers in preventing and investigating financial crimes has created much excitement among accounting majors, potentially driving more students toward a degree in accounting who otherwise would have pursued a different major.

It seems it wasn't until several major financial statement fraud schemes occurred in the early part of this century, dominating the headlines for months if not years—most notably the massive financial and accounting scandals involving Enron and WorldCom—that the term *forensic accounting* became commonplace. *US News and World Report* in 2002 issued its top 20 hottest jobs list, and topping the list was "forensic accountant." Congressional hearings, press conferences, and news stories regularly focused on the work of the forensic accountants engaged to uncover the truth in the widely publicized frauds. Since then references have become common in books, television shows, and movies relating to forensic accounting. One show in particular, *Law and Order*, has referenced forensic accounting in numerous episodes. Shows have now been developed focusing mainly on financial crimes, most notably USA network's *White Collar*.

Interesting enough, although forensic accounting has captured the attention of Hollywood and the like, the context in which forensic accounting has been used within their shows has not always been accurate. So exactly what does forensic accounting entail?

## Introduction to a Profession

What might have started with traditional accountants, tax preparers, and auditors participating in litigation-type client engagements, drawing upon their accounting training and experience to help resolve some type of dispute or other matter, has developed into the need for individuals with specialization. Today, individuals and even entire firms are focused solely on forensic accounting, litigation support, and/or business valuation. Courts, counsel, and clients seek experts who have specialized training and experience specific to the skills needed to resolve their issue, and in response colleges and universities have started offering courses at the undergraduate and graduate levels specific to forensic accounting. Auditing texts have incorporated fraud-related topics and forensic accounting techniques into the traditional auditing literature to begin to close the gap between financial statement auditors and fraud auditors.

Students today have a choice when deciding on a school to attend as well as their major: to follow the traditional accounting program or to specialize right from the beginning in the forensic accounting field. The customary route to becoming a CPA also is changing in response to this specialization. In Connecticut, for example, until 2010 individuals who wanted to become CPAs were required to work in the audit or attest area for a minimum of six months as part of their experience requirement. That requirement forced students to enter the world of public accounting, if for no other reason than to gain their six months of experience. Everything changed in Connecticut in 2010 when the State Board of Accountancy modified the experience requirement, eliminating the minimum of six months of attest experience, thereby allowing candidates to go directly from school into a boutique accounting firm to gain experience within their desired specialization. Candidates do have to gain their experience under the direct supervision of a CPA; however, the experience areas are much broader and also allow candidates working in private industry to qualify for their CPA certificate.

## Applications for Forensic Accounting

Although fraud seems to receive the most coverage, there are several other common applications for forensic accounting. In 2008, after recognizing the need for a credential in forensic accounting beyond the widely recognized Certified Fraud Examiner (CFE) designation, the American Institute of Certified Public Accountants (AICPA) announced a new credential for those CPAs who focus on forensic accounting and litigation support. The credential, Certified in Financial Forensics (CFF), became effective in September 2010, and the AICPA defined the field of forensic accounting to include a fundamental basis of knowledge along with specific practice areas or applications for forensic accounting.

**Fundamental Knowledge**

- Laws, Courts, and Dispute Resolution
- Planning and Preparation
- Information Gathering and Preserving
- Discovery
- Reporting, Experts, and Testimony

**Specialized Forensic Knowledge**

- Bankruptcy, Insolvency, and Reorganization
- Computer Forensic Analysis
- Economic Damages Calculations
- Family Law
- Financial Statement Misrepresentation
- Fraud Prevention, Detection, and Response
- Business Valuation

## Bankruptcy, Insolvency, and Reorganization

Forensic accountants can be retained on behalf of the debtor, the individual or organization contemplating or already in bankruptcy, or for the creditors, those individuals or entities that remain to be paid. The role for the work may be to assist the trustee in managing the financial affairs, searching for hidden assets, identifying pre-bankruptcy transfers, recovering funds and assets to be used to satisfy creditors, or performing business valuations to be used in resolving the bankruptcy filing. Forensic accountants also can be retained by creditors seeking to determine whether additional assets exist, or whether there were any payments made immediately prior to filing. Each creditor stands to collect less than the full amount due, so the more funds and assets that can be located and returned to the trustee, the greater the potential disbursement to the creditors. Unfortunately, bankruptcy fraud is common, and the forensic accountant's role often works toward corroborating and supporting both the disclosures and the claims.

## Computer Forensic Analysis

Two main applications for computer forensics are preservation and recovery of electronic information for evidence purposes, and electronic discovery for litigation support. Today more and more transactions are being completed electronically within both business and social settings. Valuable information and evidence can be found in files maintained in places beyond the traditional computer and server hard drives. As technology moves toward "cloud" computing, whereby information is maintained and accessed

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through the Internet, the physical location of the data will exist outside of the business, and likely outside of the country. The latest gadgets, including Blackberries, iPhones, iPads, laptops, netbooks, and cell phones, all have the ability to connect to the Internet and transmit electronic information. Knowing the types of electronic information that may exist, what form and format it possesses, where it could be located and accessed, and, most important, how to gain access to it, could be the most significant factor in prevailing in litigation or proving your case.

## Economic Damage Calculations

Damages are a key component of every lawsuit. If a party believes it has been harmed or wronged, but cannot identify or prove it has suffered damages, the likelihood of the party prevailing in litigation is not good. Two key terms for this area of litigation are causation and damages. Causation simply means the actions or inactions of one party caused the injury or loss of the other party. Damages refer to the calculated loss suffered as a result of causation. Forensic accountants are called upon to calculate losses in many contexts, including lost earnings, lost profits, lost business, and the physical loss of property (e.g., fire, flood, theft). The forensic accountant often will rely upon historical information, conduct interviews, physically inspect property, and perform trending in order to complete the damage calculation.

Forensic accountants are called upon regularly to work either side of a matter, supporting either the plaintiff or the defendant. Regardless of who the retaining party is, the forensic accountant must remain objective and unbiased, becoming an advocate only for the truth. To illustrate, forensic accountants regularly are engaged to perform damage calculations as well as review and refute damage calculations put forth by the opposing party. Two common contexts for damage calculations are litigation (lawsuits) and insurance claims. Starting with litigation, a party believes it has suffered a loss of some kind. The loss could be related to a physical incident, such as a fire or theft, or it could be related to the actions or inactions of another individual or organization. In any event, the grieved party (known as the plaintiff) initiates litigation (retains an attorney who files a lawsuit) against another party (known as the defendant), seeking to recover damages (money) from the defendant in the amount of the calculated loss. The plaintiff's claim may be relatively simple and straightforward, or it may involve detailed calculations. It is common for either party, or both parties, to retain the services of a forensic accountant to calculate the amount of potential or actual damages. The calculations may be used by the client and counsel to determine whether in fact damages actually were incurred and whether litigation should be commenced based on the damages, and, during the course of litigation, to negotiate some type of settlement in lieu of a trial.

Insurance claims work very similarly, where a party believes it suffered some type of loss and, depending on the insurance coverage it maintains, files an insurance claim to recover the loss. Here too the loss could be related to a physical loss, such as a fire, flood, or theft, or it could be related to the actions or inactions of another party.

In both contexts of damage calculations, the potential exists for fraud to be committed as well as for errors to occur. It is not uncommon for parties to include items, costs, and calculations within their damages claim that either have no bearing on the loss at hand or are unsubstantiated. In fact, unsubstantiated and intentionally inflated insurance claims are common; hence, the need for insurance fraud investigators.

Forensic accountants often are retained to prepare as well as review and refute submitted damage calculations, both in litigation and with insurance claims. The forensic accountant would seek all the supporting and corroborating information, potentially perform on-site inspections, and conduct interviews of witnesses to support and corroborate the information included in the damage calculation. These are measures not dissimilar to those employed in fraud investigations.

## Family Law

The forensic accountant can have a number of roles within marital dissolution (divorce and post-divorce) engagements, starting with the role of a strategist working with counsel and the client before the divorce is even filed. The forensic accountant may work with counsel to uncover hidden or undisclosed sources of income or assets that should have been appropriately included on a party's financial affidavit. Earnings and expenses of each party, along with earning potential, will come into play in calculating alimony and child support. It is very common for one divorcing party to be an owner or shareholder within a business, requiring a business valuation to be performed to determine the value for dividing their assets. The forensic accountant must be knowledgeable about taxes and the different tax forms, as often these may be the only documents disclosed. The ability to determine whether the financial information produced is reliable is also a very important role. The forensic accountant can expect to be disclosed as an expert witness in these cases, usually requiring testimony through deposition and trial. Due to the very nature of these personal and highly emotionally charged matters, fraud and nondisclosure are both common.

## Financial Statement Misrepresentation

This area would entail the forensic accountant being retained to examine the financial statements and disclosures of publicly traded and privately held entities and organizations, to determine whether the financial statements properly reported the balances, results, and required disclosures. If found to be improper, the forensic accountant could identify the improprieties of the financial statements, such as overstatements, understatements, omissions, and improper accounting treatments, as well as calculate the effect such identified issues would have on the financial statements. The forensic accountant also could identify any standards, rules, procedures, and regulations that were violated; assist in determining who was involved; and reveal any underlying schemes or motives for intentional misrepresentations.

## Fraud Prevention, Detection, and Response

Fraud encompasses a large area of opportunity for forensic accountants, in preventing fraud schemes from occurring, investigating fraud schemes that have occurred, and assisting owners and organizations in implementing better controls and procedures in response to a fraud scheme having been committed. The forensic accountant can be retained by an organization to proactively evaluate its systems of internal controls, financial policies, and accounting procedures before any thefts are identified, as well as to seek indications of fraud within specific areas even when no "red flags" or indications of fraud exist. However, once fraud has been identified, the forensic accountant can prove invaluable in investigating and determining what happened, who was involved, how the scheme was committed, how long the scheme went on, and other important aspects required in order to resolve the matter. There are many types of fraud and many contexts in which the forensic accountant can apply all of these services, and a detailed discussion follows further emphasizing this.

## Business Valuation

Forensic accountants are called upon to conduct business valuations within a number of contexts. The valuation may be required for purposes of dividing assets in a divorce, as discussed earlier, or may be part of some other type of litigation, such as a shareholder dispute. Conversely, valuations can be completed in nonlitigation contexts as well, such as within business transactions, in estate planning, for post-mortem estate purposes, and for gifting. In business transactions, such as purchases and sales of companies, and shareholder buy-ins and partner buy-outs, the value of the business likely may be the driving force behind the dollar amount (e.g., sales price or buy-out amount) and other terms of the transaction. Federal and state tax regulations for estates and gifts revolve around the value of each transaction. In the case of estate and gift taxes, values below a certain amount have no tax effect, but once the value exceeds the amount, taxes are due, often significant in amount. Planning for such transactions before they occur can minimize the taxes due.

## A Third Dimension: Contexts within Each Area of Specialization

To best describe how the field of forensic accounting has expanded, and how the opportunities continue to expand exponentially, we need only focus on a few contexts to see just how many opportunities currently exist for individuals with the skill set of a forensic accountant.

Let's start with the insurance industry. Within this one industry there are many different types of insurance, including performance bonds (e.g., construction bonds), life insurance, health insurance, disability insurance, automobile insurance, and homeowners coverage, to name only a few. Within every type of insurance there is the application process to obtain coverage, the payment of premiums, and the processing of claims. The potential for fraud exists within each of these areas.

For example, starting with the application process, someone with a pre-existing condition who otherwise would not be eligible for healthcare coverage intentionally fails to disclose the condition with the hopes of obtaining coverage. Another example would involve an individual who was injured outside of his or her employment, yet claims to have been injured on the job or in some type of accident, to enable him or her to file a claim to inappropriately collect payments while injured and unable to work. A third example could involve an individual who claims to be the residential homeowner of a dwelling obtains a mortgage, and insures the property as a personal residence, when in fact the individual purchased the property as a real estate investment. The individual then rents the house to multiple parties and enjoys the benefits of lower insurance premiums, as residential premiums are generally lower than those for commercial and investment properties. One last example could involve a contractor purporting to construct a building. The contractor obtains construction bonds to ensure the completion of the project. Once financing has been secured and funding has been made to the contractor, the job comes to an abrupt halt, and the contractor disappears. It is later learned the contractor was not licensed to perform the work, something due diligence should have revealed before the bond was issued. These few examples demonstrate the importance of performing diligence, and in some cases forensic accounting measures, before coverage is granted and policies are issued.

The next area pertains to premium payments, which could be either in a lump sum (in one payment) or through installments (monthly or quarterly). Fraud could be perpetrated by the customer, the policyholder, or an employee of the insurance company. For example, most states prevent a motor vehicle from being registered or re-registered until all applicable property taxes are paid and proof of insurance exists. It is not uncommon for the insured to make a payment for auto coverage to obtain evidence of payment for registration purposes, only to stop payment or cancel the payment once the vehicle is successfully registered.

Conversely, an employee working within the premiums-processing area of an insurance company could divert customer payments from the company, and conceal the thefts through adjustments and rate corrections to the customer's account, if they are concealed at all.

Lastly, claims processing exists within every type of insurance coverage. An insured party suffers a loss and must file a claim in order to get reimbursed by the policy. For example, let's examine physicians, dentists, and other medical providers who file insurance claims on a daily basis, the genesis of income and cash flows into their practice. The claims may be filed with the federal government (e.g., Medicare), state government (e.g., Medicaid), or private insurance (e.g., Cigna, Aetna, Blue Cross, etc.). Each claim identifies who was seen and treated, along with what treatments and diagnoses were provided. It is not uncommon for unscrupulous providers to submit more claims than patients seen and also for more procedures performed than actually delivered.

As another example, it is widely known that insurance coverage is required for every registered auto on the road in the United States. Coverage may be minimal or may include what commonly is referred to as collision coverage, to provide for recovery of damage in the event of an accident or total loss of the vehicle. When the gas prices soared toward \$5.00 per gallon in late 2008, many owners of low-mileage vehicles who owed more in financing on their vehicle than their car was worth, due to the declining values of low-mileage vehicles, caused their vehicles to be stolen or destroyed (often by fires), allowing them to get out of their gas-guzzling vehicles and enabling them to purchase newer, higher mileage vehicles. Similar phenomena continue to occur whenever gas prices rise above \$4.00, as was experienced throughout different times during 2011. Investigators had to determine for each loss whether the claim was legitimate or staged.

As these two examples show, a role exists for someone with skills similar to those of a forensic accountant. Expand each of the three areas of insurance into all of the other coverage types, and you start to gain a sense of just how many opportunities exist within the insurance industry alone.

A similar analysis can be performed within financial institutions. Customers open bank and investment accounts, obtain financing of many different types, make payments, deposit funds, withdraw funds, complete wire transfers, maintain collateralized assets, and report their performance and results for lending and covenant purposes. Banking employees process and approve loans, open accounts, process deposit and withdrawal requests, and manage, track, record, and reconcile the funds on behalf of their customers. As with the insurance example, each of these individual areas can be further expanded and extended to every type of financial institution in existence, including banks, credit unions, savings institutions, and investment brokerage firms, and the number of opportunities grows.

The contexts within these two industries alone, both in preventing issues from occurring as well as investigating and resolving matters, are endless. The analysis of opportunities for individuals with the skills of a forensic accountant would continue looking at all federal agencies and programs, state agencies and programs, private industry, national organizations, and small businesses. As you can see, the areas in which to apply forensic accounting are simply exploding.

## Case Study: Where's the Construction Equipment?

A local builder and general contractor procured a revolving line of credit to provide cash flows during construction projects. The loan, less than $1 million dollars, was collateralized by the construction equipment, which included an excavator, dozer, backhoe, trailer, and dump truck. Initially everything was going well, with the contractor busy building and making timely loan payments to the bank. The contractor regularly provided financial statements as required by the loan agreement, and the relationship was good. Unfortunately, the construction industry slowed, with fewer projects in process. The monthly payments continued, but were often delinquent and for less than the required amounts. Still the bank continued the relationship, monitoring the financial results and balances provided by the contractor.

A point was reached where the contractor fell behind on payments and ultimately stopped making payments altogether. The bank, appropriately concerned, reviewed the historical financial reports and failed to understand why the payments had stopped, especially since the latest reports showed positive cash balances, strong receivables, and low payables.

After communications ceased between the bank and the contractor, the bank retained a forensic accountant to perform two tasks. The first was to work with the bank's personnel to identify and seize the collateralized equipment pieces. The bank's feeling was if the loan was

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not going to be repaid, then at least it could recover some of the loss through the sale of the equipment. The second task was to review the detailed financial activity of the contractor, to determine why the cash was not used to satisfy the outstanding loan balance.

A drive to the last known address of the contractor resulted in no construction equipment, as did a drive to the contractor's residence. No equipment could be located. Subsequently, the forensic accountant determined the contractor had sold off each piece of equipment to generate cash flows, despite the fact that each piece collateralized the bank's loan. In essence, the contractor sold off the bank's equipment and diverted the proceeds, leaving the bank with no means to minimize its loss.

After many obstacles and much delay, access to the detailed books and records of the contractor was made available to the forensic accountant. The general ledger, providing details of every transaction, revealed how the declining business devoured the cash, as well as the unsubstantiated entries made to the records to misrepresent the actual balances within the reports provided to the bank. As the equipment was sold off, entries required to appropriately remove the equipment and record the corresponding sale and proceeds were never made. Rather, a separate "off the books" bank account was maintained that contained those transactions along with the proceeds. The cash balance from that undisclosed bank account was drained to zero, leaving nothing for the bank to recover against the outstanding loan. Had the detailed records been destroyed, which is common in these cases to minimize the risk of being caught and prosecuted, much of the detail regarding the contractor's actions may have never been discovered.

## Conclusion

The goal of this chapter was to provide you with a better understanding of what forensic accounting is, what it entails, and where the skills of a forensic accountant can be applied. While this provides the basis for understanding this specialized area of accounting, this field is by no means defined with any degree of finality. The venues and contexts for which a forensic accountant can prove valuable continue to expand, as do the opportunities for individuals to enter into this field. Using the field of medicine as an analogy, physicians migrated from general practitioners to specialists, often opening entire practices devoted specifically to their area of specialty. The same holds true for accountants, and the specialization has already started occurring. Many accounting firms exist today specializing only in business valuation, damage calculations, insurance claims, fraud investigations, and bankruptcy, and more likely will follow in the years to come. It is not unreasonable to think that one day there could be as many accountants specializing in specific areas of forensic accounting as there are within the traditional accounting roles.

As we move into the next chapter, we will begin to focus the forensic accounting discussions to the field of fraud, and ultimately to financial fraud.

## Suggested Readings

Crumbley, D. L., L. E. Heitger, and G. S. Smith, *Forensic and Investigative Accounting*, 4th ed. Chicago: CCH Incorporated, 2009.

Golden, T. W., S. L. Skalak, and M. M. Clayton, *A Guide to Forensic Accounting Investigation*, 2nd ed. Hoboken, NJ: John Wiley & Sons, 2011.

Hopwood, W. S., J. J. Leiner, and G. R. Young, *Forensic Accounting and Fraud Examination*, 2nd ed. New York: McGraw-Hill Irwin, 2011.

Kranacher, M-J., R. A. Riley, Jr., and J. T. Wells, *Forensic Accounting and Fraud Examination*. Hoboken, NJ: John Wiley & Sons, 2011.

## Notes

1. W. S. Hopwood, J. J. Leiner, and G. R. Young, *Forensic Accounting*. (New York: McGraw-Hill Irwin, 2008), 3, 5.
2. M-J. Kranacher, R. A. Riley, Jr., and J. T. Wells, *Forensic Accounting and Fraud Examination*. (Hoboken, NJ: John Wiley & Sons, 2011), 9.
3. D. L. Crumbley, L. E. Heitger, and G. S. Smith, *Forensic and Investigative Accounting,* 2nd ed. (Chicago: CCH Incorporated, 2005), 1-3.
4. Ibid, 1-4.
5. Ibid. 1-5
6. Ibid. 1-7