

Chapter 1

Why the World Needs Forensic Accountants

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Enron, WorldCom, Tyco, Bernie Madoff — their names are infamous, and they're all known to us for the same reason: fraud. Recent estimates indicate that almost \$3 trillion is lost globally to occupational fraud and abuse (the kind that occurs within a business) each year. That number would seem hard to believe if we hadn't all heard about the massive scale of fraud that has occurred at businesses such as Enron.

Investigating fraud can be complex. In a larger engagement, forensic accountants assist in performing various procedures that include reviewing millions and millions of documents, decoding financial information, interviewing scores of people, and gathering background information about key company players. Using technology is critical to the investigative process, and at the end of the investigation forensic accountants report their findings and sometimes provide testimony in a litigation context.

Forensic accounting as a profession has evolved in the past two decades. Recently, some universities and colleges have included it in their curricula. Organizations such as the Association of Certified Fraud Examiners (ACFE) and the American Institute of Certified Public Accountants (AICPA) now offer designations in fraud examination and forensics.

What motivates people to commit fraud? What are common types of fraud schemes? How can frauds be detected or prevented? How should they be investigated? These are some of the questions we explore in this book. To get you started, we offer an overview in this chapter of what forensic accounting is and why the proliferation of fraud has created such a strong need for it.

Accounting versus Auditing: Defining Our Terms

Accounting and auditing are substantially interrelated. In brief, *accounting* is the preparation of financial statements, and *auditing* is the examination of those financial statements. Every collegiate accounting program also offers auditing. Auditors have traditionally been certified public accountants (CPAs).

In this section, we examine accounting and auditing more closely to illustrate what they are and how they interrelate.

Working as an accountant

What is accounting? When Frimette teaches introductory accounting classes, she defines accounting as the gathering, analyzing, recording, summarizing, reporting, and interpretation of financial transactions for an entity. Wow, what a mouthful! What does it mean? Accountants gather information about transactions, record that information, and then massage it so that the end product is a set of financial statements that various types of users can use to make rational financial decisions about the entity.

The recipe that accountants use to do all this gathering, recording, and massaging is called *generally accepted accounting principles* or GAAP. Way back in 1494, a Franciscan monk in Venice named Friar Luca Pacioli published a book called *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (Everything about Arithmetic, Geometry, and Proportion). In it, Fr. Pacioli described the double-entry method of accounting — the method we still use today. *Double-entry accounting* reflects the fact that businesses have two sides:

- ✔ They have assets.
- ✔ They have claims on those assets, as well as sources that create the assets.

Although the basics of double-entry accounting have been around a while, business transactions have become much more complicated than they were in 1494. To refine how accounting should be used in today's complex world, we have guidelines. In the United States, these guidelines — GAAP — are determined by the Financial Accounting Standards Board (FASB), an accounting think tank in Norwich, Connecticut. Most developed countries have their own version of the FASB and GAAP. There is even an International Accounting Standards Board (IASB) that sets International Financial Reporting Standards (IFRS). All these systems of standards have a lot of similarities because they are all based on Fr. Pacioli's work.

In the United States, financial accountants may work inside industry (working for one company) or in public accounting (having many clients). They help companies prepare their financial information and present it in the form of financial statements.

For detailed information about working as an accountant in the United States, check out *Accounting For Dummies*, 4th edition, by John A. Tracy, CPA (Wiley).

Working as an auditor

An audit is an independent, objective, and systematic examination of underlying data in order to form an opinion about someone else's assertions. Wow, another big definition! Let's pull it apart a bit.

First, let's focus on what *independent* and *objective* mean. An auditor must be independent of the entity he audits, which means he cannot have any relationship with that entity other than the audit itself. He has to be objective, meaning he may not enter the engagement with any preconceived notions about the client or the work he is to perform.

Next, consider what *systematic* means, or what it means for an auditor to perform his work systematically. Every auditor has to prepare an audit plan before she begins the actual audit. The audit plan explains what types of evidence the auditor will analyze and the tests she plans to perform. The auditor develops the plan based on substantial preliminary risk assessment about the client. After the plan is developed, the auditor may change the preliminary risk assessment if additional information is discovered during the planned audit procedures. If the preliminary risk assessment is modified, the auditor must document the reason for modifying the preliminary risk assessment.

After the auditor has gathered enough information, she gives an opinion about whether someone else's statements are true or not. In most cases, audits focus on a company's financial statements. Company management is making a variety of assertions in those statements:

- ✔ That the financial statements are inclusive of all transactions
- ✔ That all transactions have really occurred
- ✔ That assets and liabilities exist and are recorded at the proper value
- ✔ That the company has rights to all its assets
- ✔ That all the necessary *disclosures* (notes to the financial statements) have been made

Management also asserts which set of standards (such as GAAP) the company is using as its guideline. The auditor's job is to test all these assertions thoroughly enough to form an opinion about their validity.

Whereas most audits are financial statements audits, other kinds of audits exist as well. *Compliance audits* check to see if an entity is in compliance with certain rules. For example, if the IRS knocks on your door, it wants to check whether your tax returns were prepared in accordance with the Internal Revenue Code. *Operational audits* are used to determine if an entity is operating efficiently.

To perform a financial statement audit, most jurisdictions require that the auditor be a CPA in that jurisdiction. The CPA license is certainly required when performing financial statement audits of companies whose securities trade in the public markets.

Generally, the ethics for auditors are embodied in the Code of Ethics of the American Institute of Certified Public Accountants (AICPA). Every CPA licensing board (there are 54 of them) has its own code of conduct for accountants. However, for the most part, they are all similar to the AICPA's code of conduct.

To get the nitty-gritty details about life as an auditor, pick up a copy of *Auditing For Dummies* by Maire Loughran (Wiley).

Adding "Forensic" to the Mix

Forensic means having to do with the court or with public debate. *Forensic accounting* happens when special accounting and auditing techniques are used to gather and present information for the courts or other legal matters.

Taking accounting and auditing to the courtroom

Sometimes the courts, or lawyers, need a deeper understanding of financial transactions. Rather than wade through the transactions themselves, they retain a forensic accountant.

In the case of a criminal act, lawyers may need help figuring out if a financial fraud has occurred. Who better to determine this than an accountant, who already has a deep knowledge of how to follow transactions through the maze of books and records? The forensic accountant may not only help determine if a fraud has occurred but also determine how much money was taken and where it went. This information may be crucial if victims are trying to get back any of their stolen funds.

Accountants are often part of a team that may be defending a taxpayer in a tax fraud case or a company accused of financial statement fraud. The defense may call upon an accountant to explain to the courts why certain transactions or financial statements are not fraudulent. An accountant may practice tax forensics even when it's not a direct tax case. Every white-collar crime attorney knows that the U.S. Attorney's office will look at a suspect's tax returns. If they can't get the suspect on the original criminal accusation, they will try to get him on tax fraud. That's how Al Capone was finally convicted! Attorneys weren't able to get him for all the suspected murders he was involved in, but they did put him away for tax evasion. We've reviewed and/or prepared many a suspect's tax return at the request of that person's criminal defense attorney.

Accountants are also involved in *business valuation*, which means determining the value of a small business. Business valuation comes into play in many situations, including:

- ✓ Disputes between partners
- ✓ Buy-sell agreements
- ✓ Mergers and acquisitions
- ✓ Estate planning and gifting
- ✓ Divorce
- ✓ Eminent domain cases
- ✓ Torts

Getting special training and licenses — or not

As of this writing, you don't need any specific licenses or training to call yourself a forensic accountant. (That situation is subject to change as the field grows.) Many forensic accountants get on-the-job training. They are thrust into a situation that requires forensic techniques, and they need to catch on fast. Fortunately, most accountants adapt easily to the demands of this field. Our skills as auditors, knowledge of transactions, and natural skepticism make it easy for us to adapt. And when on-the-job training involves working alongside a more seasoned forensic accountant, you often pick up the necessary skills even faster.

Many of the large accounting firms have in-house forensic accounting training programs. The various state CPA societies also offer training and education in many areas of interest to accountants, including forensics.

Two of the most prominent organizations that offer training in forensic accounting also offer certification. These are the Association of Certified Fraud Examiners (ACFE) and the National Association of Certified Valuation Analysts (NACVA). Both organizations offer many education programs as well as certification. ACFE is probably the better-known organization. Its former president, Joseph T. Wells, CFE, CPA, is a prolific writer on the subject of forensic financial examination and is often quoted by the press. ACFE also issues the Certified Fraud Examiner (CFE) designation, which requires documented experience in the field, education, and testing. The CFE does not require that you have an accounting background. We talk more about the CFE and other certifications in Chapter 2.

Why bother with training and certification if it isn't required? First, getting additional education is never a bad thing — especially if you know that forensic accounting is going to be your niche. Second, being recognized as having the knowledge and skills sets to perform investigations will give you an edge over those who don't have these skills. Finally, consider the fact that forensic accountants often have to testify in court. A jury may be more likely to accept that you're an expert if you have specialty certifications.

Creating the Need for Forensic Accountants: Fraud

Investigating fraud is a growing industry. The more fraud that occurs, the more the need for forensic accountants expands. In its annual report, the ACFE estimated the cost of fraud in 2009 to be \$2.9 trillion and reported that nearly a quarter of those fraud cases involved losses of \$1 million or more.

In this section, we touch on what fraud is, who the perpetrators and victims of fraud may be, and why fraud happens. We also discuss in more detail how much fraud is happening in the business world today.

What is fraud, anyway?

Fraud is theft. Fraud is stealing. Fraud is profiting by deceit or trickery. Fraud involves the theft of funds or information or possibly the use of another's assets without permission.



Fraud may be done directly or indirectly: Someone can steal something outright or can encourage stealing. Fraud can also take the form of not caring when you know someone else is doing the stealing. Fraud requires at least some degree of intent to commit the wrong or to go along with the wrong. Therefore, errors in judgment are not a fraud.

Unlike a lot of other types of theft, fraud does not usually involve physical violence. Therefore, fraud is considered *white-collar* crime. Some people hold the belief that fraud is a “clean” form of crime, but fraud can have a devastating effect on its victims. Many victims of Enron and Bernie Madoff, for example, lost their entire savings and had to drastically alter their lifestyles.

Frauds can be small, big, or gargantuan. A thief who steals a credit card and charges a few hundred dollars to it is committing a small fraud. Madoff made off with an estimated \$65 billion.

Who commits fraud, and who are the victims?

Frauds are committed by businesses, big and small, and by individuals. And those same entities can all become victims of fraud. Here, we introduce several scenarios to show how business and individuals may commit or be victimized by fraud.

Businesses committing fraud on individuals

Businesses often commit frauds against their individual customers. It's not hard. You may even have been a victim.

Do you have a credit card? How do you know that your credit card company is computing your finance charge correctly? Imagine if the card company performed the interest computation so that you got charged just one penny more. A penny isn't a big deal; you wouldn't know about the overcharge or miss the money. But if you multiply the number of credit cards issued by that bank by one cent, the result can be a tidy sum.

Now, take this scenario a step farther. Because you have a small balance on your credit card, you get charged only a penny more. However, finance charges are usually computed using multiplication. You get charged a penny, but the guy down the street happens to be carrying a large balance so he gets charged 20 cents more. If you don't pay your full balance, next month you're paying interest on the remainder. If part of your balance is a fraud and you don't catch it, you get to pay interest on the fraudulent interest, which gets computed fraudulently as well. A one-cent fraud on each account can turn into millions of dollars for the credit card company very quickly.

Banks and bank employees have been known to commit frauds like this. Unless someone such as a forensic accountant recomputes the interest, no one knows.



In Frimette's neighborhood, there was a small beauty salon that did not have the cash register electronically compute sales tax. Every time someone got a haircut, the sales tax was computed differently. Customers long suspected that this situation was a ploy to raise revenue. To this day, we still can't figure out if the cashier was pocketing the difference between the collections and the true amount or if she was following the owner's instructions. Or it may not have been a fraud at all. Maybe the cashier just couldn't do arithmetic and didn't fully understand the importance of getting the sales tax right.

Individuals committing fraud on businesses

Obviously, individuals commit frauds on businesses, too. You may know someone who has perpetrated such a fraud, or you may have done it yourself. Some of these frauds are small: Have you ever used the office copy machine or postage meter for personal reasons? Have you ever taken home some office supplies? C'mon now, come clean!

Here's another common fraud that department stores complain about all the time: A woman is invited to a special event and needs an appropriate dress. She buys a dress for the event but doesn't take off the tags; she somehow manages to stick the tags inside the garment. (They may scratch a little, but it's worth the discomfort.) The day after the event, she takes the dress back to the store for a refund. Is this fraud? Yes. You may be wondering "What's the harm? The store has the dress back!" The problem is that the store now has a *worn* dress. Maybe the dress has a little stain that you didn't even notice, and as a result the dress has to go on a clearance rack. Even if the dress is returned in perfect condition, the store has to deal with the cost of having salespeople around to sell, take returns, and restock garments. Not to mention that the store may have lost the opportunity for a real sale while the dress was out partying with the fraudster.

Other types of fraud perpetrated by individuals against businesses can be much larger. These may include (but are definitely not limited to) insurance fraud and mortgage fraud. *Insurance fraud* is the filing of false insurance claims or lying on an insurance application. *Mortgage fraud* could be lying about the applicant's income on an application or inflating the value of the property being mortgaged.

The key to preventing frauds that individuals commit against businesses is for those businesses to maintain strong *internal controls*: paperwork and procedures that govern the way the business is run. For much more on this subject, be sure to check out Part VI.

Individuals committing fraud on individuals

Individuals defrauding individuals is very common. It happens in more ways than we can count, and we're accountants! We could write a whole book on this topic alone, but in this book Part III is where you can find the goods.

Do you know anyone who has been sold an unnecessary life insurance policy by a slick salesman? Do you know anyone who had an unnecessary repair done on his or her home? Then you know someone who has been defrauded by another individual.

Why does fraud occur?

In the beginning, there was the *fraud triangle*. Experts have long considered the three components of fraud to be motivation, rationalization, and opportunity. These days, we've created a fraud quadrangle because the component of expertise has been added to the mix. Keep reading to find out what the four sides of the quadrangle represent.

Motivation

There are a few principal motivators for fraud. One is need. Often fraud starts out as a response to a need. Bob is getting a low salary, Aunt Hilda needs surgery, and Bob “borrows” from the company to pay Aunt Hilda’s bills. He has every intention of paying off the hidden debt. However, after the doctors get done with Aunt Hilda, the amount she owes is much higher than originally expected. Bob keeps trying to pay the debt back, but spends all his energy just trying to keep his “borrowing” from becoming known.

CASE FILE



In Chapter 7, we tell the story of Barry Minkow of ZZZZ Best Company. The fraud he committed was motivated by need. Minkow needed to borrow money to keep his small carpet cleaning business running. Then he needed more, and then even more. The legitimate part of his business couldn't support the amount of funds he was borrowing, so he made up sales just to be able to look better to the banks and borrow more money. Before he knew it, the whole thing got out of hand. By the end, about 85 percent of the reported ZZZZ Best sales volume was fictional.

Is need the only motivator for fraud? No. Another biggie is adrenaline. Some people just get off on the high they feel from getting away with something. Their only need is to experience the rush on an ongoing basis.

Rationalization

The most common rationalization for fraud that we've heard is this: “They owe me. I work hard, and they pay me very little for my work, so I'm just going to take.” We see this rationalization when employees perceive that management treats them poorly.

Another common rationalization is “They won't miss it.” We tend to see this rationalization when the victim is blessed with riches and the perpetrator much less so.

Executives committing financial fraud have their own rationalizations for their behaviors. For instance, they may tell themselves that falsifying financial reports is acceptable because doing so maintains the company stock price and saves jobs. In essence, anything goes as long as the stock price increases and shareholders are happy. (Some of them may also assume that the public is ignorant and will never know what's going on.) Executives may also rationalize that if a fraud occurs only once, and they plan to correct it in the future, no real harm is done. Or, they may tell themselves, "This is the way business gets done — some of our competitors are doing it, so we have to do it as well."

Opportunity

Sometimes fraud is just easy to commit. For example, if you don't have a firewall on your computer system, you're essentially inviting a hacker to steal your personal information. Often people (and businesses) lack the foresight to see the holes that criminals see. Therefore, forensic accountants have to be ever vigilant and try to think like thieves. This way, we can outsmart the thieves before the opportunity is found.

CASE FILE



A large membership organization with about 650 employees and offices in New Jersey announced that it was merging one division with an organization in Texas. Most of the jobs in New Jersey would be eliminated in about six months as a result of the merger. Employees rationalized that the employer owed them because they had worked hard all these years and were being rewarded with pink slips. They also needed computers at home to work on their résumés for their upcoming job searches. They started taking computers home. Because the organization didn't have security, employees literally walked the computers out the front door.

Management got wind of the disappearing computers so it posted security guards at the elevators. The employees were not deterred. They started boxing up the computers and mailing them home. An alert mailroom clerk realized something was fishy with all these heavy, large boxes being mailed to employees and blew the whistle. An edict was issued that all parcels not being mailed to a known customer had to be approved by a manager. The organization finally got some internal controls in place, but by that time the losses had already added up.

Expertise

In the old days, criminals valued the skill of safe cracking. If you were going to rob a bank or a diva's jewels you had to know how to get into the safe. Today, many frauds are committed using computers and computer networks. It's essential to have a certain level of computer expertise, therefore, to commit fraud. Have you received a spam e-mail lately? We don't even know how to send an e-mail to "undisclosed-recipient@yahoo.com," but a lot of fraudsters out there sure know how.

For many frauds, you don't have to have high-level skills; your expertise comes from having figured out how to manipulate the system at hand. If you know how to trick your boss into signing a check without looking, for example, you can commit a fraud.

The incidence of fraud

In its *2010 Report to the Nations on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) indicates that organizations around the world lose an estimated 5 percent of their annual revenues to fraud. When you consider how hard most businesses work to eek out every dollar of revenue possible, you realize that a 5 percent loss is enormous.

Here are some other key findings from the ACFE report that offer some perspective on what occupational fraud looks like:

- ✓ **Fraud schemes are costly:** The median loss caused by the occupational fraud cases in the study was \$160,000. Nearly one-quarter of the frauds involved losses of at least \$1 million.
- ✓ **Fraudsters leave footprints behind:** Fraud perpetrators often display warning signs that they are engaging in illicit activity. The most common behavioral red flags include living beyond their means and experiencing financial difficulties.
- ✓ **Frauds have a long incubation period:** The frauds in the study lasted a median of 18 months before being discovered.
- ✓ **Frauds are similar globally:** Most of the trends in fraud schemes, perpetrator characteristics, and antifraud controls are similar regardless of where the fraud occurred.
- ✓ **Tips are key in detecting fraud:** Occupational frauds are much more likely to be detected by tip than by any other means.
- ✓ **Executive-level fraud is most damaging:** Frauds committed by owners and executives are more than three times as costly as frauds committed by managers and more than nine times as costly as employee frauds. Executive-level frauds also take much longer to detect.
- ✓ **Small businesses are especially vulnerable to occupational fraud:** These companies typically lack the resources for instituting antifraud controls.



You can read the ACFE's *2010 Report to the Nations on Occupation Fraud and Abuse* yourself by visiting www.acfe.com/rtnn/2010-rtnn.asp.

Identifying Potential Employers: Who Hires Forensic Accountants?

Considering your options as a forensic accountant? We offer lots of career talk in Chapter 2. For now, keep in mind that many types of entities hire forensic accountants. Here are the biggies:

- ✔ **Government:** The federal government is probably the largest organization hiring forensic accountants. Traditionally, the Federal Bureau of Investigation (FBI) investigated frauds. Now, in addition to the FBI, many federal agencies have their own Office of the Inspector General (OIG) that investigates financial crimes and frauds particular to that agency's mission. Often crimes are committed that cross the thresholds of several agencies. In these cases the agencies tend to form task forces that bring in agents from many agencies to work together.
- ✔ **CPA firms:** Many accounting firms have divisions that employ forensic accountants. They are hired by attorneys, companies, and individuals who have a problem and need the services of a forensic accountant to help uncover the truth.
- ✔ **Attorneys:** Some large law firms have their own forensic accountants on their investigative staff. These forensic accountants are used to support cases involving financial frauds, asset division and child support in divorce cases, mergers and acquisitions, securities frauds, and other types of cases.
- ✔ **Consulting firms:** Some consulting firms have forensic accountants on staff and work on cases just like CPA firms do.
- ✔ **Insurance and companies:** Insurance companies hire forensic accountants to investigate fraud on applications for life insurance as well as false claims on workers' compensation and death benefits.
- ✔ **Retail companies:** Retail companies hire forensic accountants to reduce product theft from consumers and employees by developing and auditing policies and procedures.