

## Forensic and Investigative Accounting

### Chapter 1

## Introduction to Forensic and Investigative Accounting

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## Forensic Accounting vs. Fraud Auditing

*Fraud Auditor:* An accountant especially skilled in auditing who is generally engaged in auditing with a view toward fraud discovery, documentation, and prevention.

## Forensic Accounting vs. Fraud Auditing

*Forensic Accountant:* A forensic accountant may take on fraud auditing engagements and may be a fraud auditor, but he or she will also use other accounting, consulting, and legal skills in broader engagements. In addition to accounting skills, he or she will need a working knowledge of the legal system and excellent communication skills to carry out expert testimony in the courtroom and to aid in other litigation support engagements.

## Forensic Accounting Defined

- n *Time:* Forensic accounting focuses on the past, although it may do so in order to look forward.
- n *Purpose:* Forensic accounting is performed for a specific legal forum or in anticipation of presentation before a legal forum.
- n *Peremptory:* Forensic accountants may be employed in a wide variety of risk management engagements within business enterprise as a matter of right, without the necessity of allegations (e.g., proactive).

## Forensic Accounting Defined

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.

## Historical Roots of Accounting

10,000 years ago—Temple priests took inventory of village livestock.

3,000 B.C.—Scribes recorded ruler's wealth.

1887—American Association of Public Accountants (later becoming the AICPA) was formed.

1896—New York State legislated the first CPA law.

1900—School of Commerce, Accounts, and Finance at New York University opens.

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## Historical Roots of Accounting

- 1902—Congress calls for audit reports for large corporations.
- 1913—Federal Reserve Board created.
- 1913—Federal income tax law was passed.
- 1914—Federal Trade Commission created.
- By 1921—All states had passed laws requiring exam for CPA certificate.

## History of Financial Reports and Legal Challenges

- n Financial reports were created by accountants long before independent audits were mandated.
- n Current system of accounting checks and balances is relatively recent.

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## History of Financial Reports and Legal Challenges

- n Before financials were audited by outside experts, the courts often handled challenges and brought in experts to give testimony.
- n Practice of forensic accounting was common even before independent accountants were asked to certify financial statements in auditing engagements.

## Threads of Forensic Accounting

1817—Canadian court decision of *Meyer v. Sefton*.

1824—James McClelland started his business in Glasgow, Scotland.

1856—In England, the audit of corporations became required.

## Forensic Accounting in Print

- n Articles on arbitration, fraud, investigation, and expert witnesses began appearing in the late 1800s.
- n After a comment in 1925 by the Chairman of the U.S. Board of Tax Appeal, *The Journal of Accountancy* proposed that educational institutions should start including in their curricula the study of the law of evidence.

## Phrase “Forensic Accounting” Is Born

- n Maurice E. Peloubet coined the phrase in print in 1946.
- n Max Lourie wrote an article and also claimed to coin the phrase, seven years after Peloubet. Lourie’s article voiced three important positions:
  - An accountant should not have to attend law school to learn the art of expert testimony.
  - Colleges and universities should deliver forensic accounting training.
  - Forensic accounting reference books and textbooks should be developed for students.
- n The first forensic accounting book appeared in 1982.

## FBI and Forensics

- n During WWII, the FBI employed approximately 500 agents who were accountants.
- n In 1960, about 700 FBI agents were Special Agent Accountants.
- n Today, there are more than 600 FBI agents with accounting backgrounds. The FBI has a Financial Crimes Section that investigates money laundering, Internet crimes, financial institutions fraud, and any other economic crime.

## AICPA Practice Aid

In 1986, the AICPA broke forensic accounting into two broad areas: investigative accounting and litigation support.

The types of litigation services were further broken down in Practice Aid 7, listing:

- damages
- antitrust analyses
- accounting
- valuation
- general consulting
- analyses

## Panel on Audit Effectiveness

In 1998, the Public Oversight Board appointed the Panel on Audit Effectiveness to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest.

## Panel on Audit Effectiveness

In 2000, the Panel issues a 200-page report, *Report and Recommendations*, which includes a recommendation that auditors should perform forensic-type procedures during every audit to enhance the prospects of detecting material financial statement fraud.



## AICPA Fraud Task Force Report

In 2003, the AICPA's Litigation and Dispute Resolution Services Subcommittee issued a report of its Fraud Task Force entitled, "Incorporating Forensic Procedures in an Audit Environment."

The report covers the professional standards that apply when forensic procedures are employed in an audit and explains the various means of gathering evidence through the use of forensic procedures and investigative techniques.

## Accountant's Role in Fraud Detection

- n In the early 1980s, companies began to use computers to perform their record keeping.
  - n Intense competition caused auditing fees to fall as much as 50% from the mid-1980s to the mid-1990s.
  - n Auditors cut costs by reducing the process of reviewing hundreds of corporate accounts. They grew more reliant on internal controls.
  - n The *Journal of Forensic Accounting* was created.
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## Accountant's Role in Fraud Detection

- n Top executives were able to circumvent internal controls and manipulate the records.
  - n This lead to situations such as Enron, WorldCom, Xerox, Adelphia Communication, and the fall of Arthur Andersen in the early 2000s.
  - n Due to the financial disaster of companies such as Enron and WorldCom, there will be an increase of forensic techniques in audits and an increase in fees.
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## Accountant's Role in Fraud Detection

- n Some accounting experts believe that every audit engagement should include much more skepticism and detailed review of transactions.
- n Other accounting experts suggest that only special engagements specifically targeting fraud can adequately and effectively root out the problem.
- n The Big Four and the next two accounting firms believe that every public corporation should have a forensic audit every three years.