

Seventh
EDITION



FORENSIC AND INVESTIGATIVE ACCOUNTING

CRUMBLEY | HEITGER | SMITH

 Wolters Kluwer

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Forensic and Investigative Accounting

Seventh Edition

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Preface

Forensic and Investigative Accounting fills a void in accounting education literature by providing the first broad-based text covering all the important topics that have come to be identified with modern forensic accounting. Certainly, there are books on fraud auditing, litigation support, valuation damages, cybercrime, and other key forensic topics, but other textbooks are not specifically written to cover the forensic accounting waterfront. The authors hope that teachers will find *Forensic and Investigative Accounting, 7th Edition*, a particularly powerful teaching and learning tool. The twin towers of forensic accounting—litigation support and investigative auditing—are covered in detail. The 7th edition includes valuable research from the 2014 AICPA Survey of International Forensic Accounting Trends, EY's Global Forensic Data Analysis Survey, KPMG's 2013 Integrity Survey, PWC's 2014 Global Economic Crime Survey, Deloitte's Snap 2013 Fraud Survey, Seventh Kroll's 2013/2014 Global Fraud Report, and the 2013/2014 Global Retail Theft Barometer.

Some of the new topics are COSO Cube Updated, Standards for Internal Control in Federal Government (2014), Securities Whistleblower Incentives and Protection provisions, Financial Secrecy Index, Defense Department's Contract Audit Manual, International Standards for Professional Practices of Internal Auditors, forensic data analytics, chessboard fraud risk assessment technique, additional details on avoiding Daubert challenges, more eyewitnesses and spotlight stories, and new problems, cases, and pop quizzes. This edition brings the reader up-to-date with the latest cybercrime activity, valuation, and damages cases, and it documents the latest corruption schemes and explains how to find and prevent them.

Please visit <http://www.cchgroup.com/Resources> for any periodic updates or clarifications that may become available related to the 7th Edition of ***Forensic and Investigative Accounting*** as well CCH's Daily Tax Day News, Tax Briefings and other items of interest. This textbook is a valuable, recommended study aid that can assist beginning and experienced forensic accounting practitioners in preparing for certification exams.

Today's forensic accounting teachers and students have a difficult task in studying this developing topic, but they are compensated by the fact that forensic accounting is red hot and relevant. These students can find jobs and obtain nice pay checks. In 2002, Congress took up the financial markets reform mantle and passed the Sarbanes-Oxley Act, which was in part designed to restore financial accountability by preventing and punishing fraud. The Act created a new independent accounting oversight group called the Public Company Accounting Oversight Board (PCAOB), subject to Securities and Exchange Commission review. Sarbanes-Oxley, recent SEC actions, aggressive actions against external auditors by the PCAOB, international pronouncements by the Institute of Internal Auditors and the AICPA, and new rules promulgated by the various stock exchanges have all worked to change the perception of who is responsible for detecting and fighting fraud in financial statements and throughout the corporation and other entities. External auditors, internal auditors, company management, and audit committees are all charged in one way or another with fighting fraud under new initiatives. Yet, the task of fraud detection has proven so difficult (e.g., Bernard Madoff, Sir Robert Allen Stanford, Rita Crundwell, and Satyam Computer Services) that the continued growth in forensic accounting specialists seems assured along with the development of the forensic accounting discipline to match wits with new advanced technological and fraud schemes. The federal government's Affordable Care Act and the shortfalls in many states' budgets should provide much work for forensic accountants.

Students and teachers alike will find that forensic accounting also is extremely interesting, and the authors of ***Forensic and Investigative Accounting, 7th Edition*** worked hard to build a sense of interest and yes, even excitement into the text. Some would argue that forensic accountants are more like "Quincy" (a once popular TV show about a crime-solving coroner) or the CSI characters than the traditional starch-collared, numbers-cruncher. Forensic accountants work on books and records, but often in the context of legal conflicts and even criminal activities.

Forensic and Investigative Accounting, 7th Edition demonstrates that this developing discipline is challenging. As the text demonstrates, an effective forensic accountant needs an understanding of accounting, investigative auditing techniques, computers, criminology, and courtroom procedures. Many forensic accountants

will further specialize and have varying concentrations of these five sets of knowledge and skills.

All three authors are teachers, forensic accountants, and perhaps most of all, forensic accounting fans. While there are many complex forensic issues explained in this book, the authors worked hard to try to convey to students the contemporaneous nature of forensic accounting—forensic accounting is constantly developing in the news, in the legal and regulatory system, and as part of the accounting industry.

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The authors believe that forensic accounting should be fun to teach, and with the many Internet-related assignments in the chapter exercises, students are encouraged to continue to seek out new stories and developments as they occur. Of course, studying a discipline that is experiencing such dramatic change will be challenging. However, there are plenty of fundamental concepts and topics that require a good deal of earnest attention and concentration that will help keep both students and teachers anchored to reality.

In today's climate all accountants—external, internal, corporate accountants and yes, the forensic accounting specialist—must develop forensic competencies. The authors believe it will only be a matter of time before all accounting majors will take one or more forensic-type courses. The authors agree with James Gordon Brown, Prime Minister of England, that “what the use of finger prints was to the 19th century and DNA analysis was to the 20th, forensic accounting will be to the 21st century.”

July 2015 D. Larry Crumbley Lester E. Heitger G. Stevenson Smith

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Finally, we’d like to thank our fellow instructors who adopt this book and the students who support our efforts.

D. Larry Crumbley
Lester E. Heitger
G. Stevenson Smith

How to Use This Book

Forensic and Investigative Accounting is organized to engage students in the study

of forensic accounting. Special features, end-of-chapter exercises, appendices, and a forensic glossary are provided to further assist students in the learning process.

Chapter Openings

All chapters begin with the same elements: a list of the learning objectives and an overview. This information provides a framework for understanding the material that will be studied in the chapter. **Special Features**

Hundreds of forensic stories, featured factoids, and illustrations are interjected throughout the chapters.

Eyewitness features are typically descriptive short snippets expressing a forensic event, action, or slant on an issue.

Spotlight features are used to interject a longer story in the forensic news or a statement on a forensic concept.

Ethics features are used when a forensic related standard or ethics-related authority is reproduced.

Law and Order features identify a legal case or regulatory ruling.

Examples are used when a specific situation is used to illustrate an important point.

End-of-Chapter Materials

Every chapter ends with a conclusion that ties together the ideas presented in the chapter and with the chapter opening and overview help to give students a point of reference for additional study. End of chapter exercises are used to help the student assess his or her understanding of the chapter's salient points. Some will help direct the student to additional research. The exercises also provide the instructor with a ready means to evaluate student understanding of the material.

End-of-Book Materials

A special forensic glossary is offered at the end of the book that can be referenced throughout the student's reading. Appendices offer additional source materials for extended reading and research. **Website**

Please visit <http://www.cchgroup.com/Resources> for any periodic updates or clarifications that may become available related to the 7th Edition of **Forensic and Investigative Accounting** as well as CCH's Daily Tax Day News, Tax Briefings and other items of interest.

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Please visit www.CCHGroup.com/Resources for any periodic updates or clarifications that may become available related to the 7th edition of *Forensic and Investigative Accounting* as well as CCH's *Daily Tax Day* news, tax briefings and other items of interest. **PART 1**

The Field and Practice of Forensic Accounting
Chapter

1

Introduction to Forensic and Investigative Accounting

With the virtual media cottage industry blooming on the corpse of bankrupt Enron and its complicated array of alleged financial shenanigans, could it be just a matter of time before some television executive plots a new drama starring...forensic accountants?

—Catherine Valenti, ABCnews.com¹

OBJECTIVES

After completing Chapter 1, you should be able to:

1. Distinguish forensic accounting from fraud auditing.
2. Understand the definition of forensic accounting.
3. Understand the threads of accounting history and other commercial developments that led to the creation of today's forensic accounting.
4. Understand how public auditing trends may have led to accounting scandals.
5. View the parallel developments of formal accounting practice, accounting literature, and forensic and investigative accounting.

OVERVIEW

While forensic accounting is not a new discipline, it has developed rapidly and gained status in the accounting and legal communities. The media have been energetically covering accounting scandals and intrigues, which are often characterized as the forensic accountant's "beat." If the number of articles written on the topic is any indication, readers of such esteemed newspapers as The Wall Street Journal and The New York Times are captivated by the forensic accounting topic. The good news for accounting students is that if current trends persist, forensic accounting and its many subspecialties will provide some very interesting and lucrative career opportunities.

Accountants, long the butt of bean-counter jokes, are viewed a bit differently these days. Major scandals certainly have tarnished the image of the accountant, but the "forensic accountant" is getting a lot of respect. Gordon Brown, then the British Chancellor of the Exchequer, on October 10, 2006, said that "what the use of finger prints was to the 19th century and DNA analysis was to the 20th, forensic accounting

will be to the 21st century.”

His partner in the movie, *The Other Guys*, asks Allen Gamble (played by Will Ferrell) a detective/ forensic accountant this question:

Terry: So you think he is dealing in drugs?

Allen: No! It's not drugs! It's not murder! It's economies influx, shadow banking, and offshore accounts. We're going to have to do paperwork, due diligence, and financial ledgers.

After the terrorist attacks of September 11, 2001, it was determined that a number of the perpetrators used debit cards that had been set up by cash—largely untraceable—brought into the country. There were even some transactions with no moving money, possibly using offsetting receivables and payables, that were still traceable.² The FBI agents employed forensic-type techniques when looking at credit cards, phone records, and interviews with terrorists' neighbors and friends. Shutting down the cash flowing into the terrorists' network was accomplished using financial sleuths.

Accounting also made the big screen, and its new notoriety has been satirized in the popular media. A short film entitled *The Accountant* won an Academy Award in March 2002. The hard-drinking, chain-smoking backwoods movie accountant cynically states that “numbers and facts are already fudged here and there; it's called accounting.” Leon Martel (played by Tracy Howe), a forensic accountant, has been a recurring character in three “Law and Order” series: the original, “Law and Order: Criminal Intent,” and “Law and Order: SVU.” A Jack Ziegler cartoon in the March 10, 2002, *New Yorker* magazine shows a couple of women at a bar with one telling the other that “being an accountant gives him that extra aura of danger.”³

These may be unwelcome visions of accounting, but they point out that accounting—and forensic accounting, in particular—are not only noteworthy, but newsworthy. In light of the notoriety and scandal, one movie analogy does seem appropriate: Similar to the agents in the film *Men in Black*, the forensic accountant's armory must be equipped with talent to suit every purpose, from detecting cooked books, to kiting, to money laundering. As Al Pacino said in the movie *The Recruit*, “Things are not what you think they are.” Is your business losing money to fraud like pop flies in the baseball stands?

This chapter provides a broad definition of forensic accounting and creates a frame of reference for students to read and understand the rest of the book. Upon tracing the threads of forensic accounting through its history and development, students will understand forensic accounting to be a challenging discipline that substantially

interacts with economics, finance, information systems, criminology, and the law. Terry McCarthy, audit partner with Green & Seifert, “likens it to ‘CSI’ or ‘Law & Order,’ but instead of figuring out the trajectory of a bullet, you’re trying to find out how a transaction occurred.”⁴

After reading and studying our textbook, we hope people cannot say the following about forensic accountants and auditors:

“The bad guys are a lot slicker today,” I said.

“They ain’t no slicker, son. The good guys are just dumber.”⁵ Remember, there are only three things certain in life: death, taxes, and fraud.

Definition and Development of Forensic Accounting

¶ 1001

DEFINING FORENSIC ACCOUNTING

Many people believe forensic accounting and fraud auditing are synonymous. They are not. A fraud auditor is an accountant especially skilled in auditing who is generally engaged in auditing with a view toward fraud discovery, documentation, and prevention. A forensic accountant may take on fraud auditing engagements and may in fact be a fraud auditor, but he or she also will use other accounting, consulting, and legal skills in broader engagements. In addition to the accounting and investigative skills that should certainly be present in the fraud auditor, the forensic accountant needs a working knowledge of the legal system and excellent quantitative analysis and communication skills to carry out expert testimony in the courtroom and to aid in other litigation support engagements.

Bruce Dubinsky, a partner in Klausner, Dubinsky & Associates, stresses this broad approach by emphasizing that there are plenty of accountants getting involved who should not be involved in the niche. “‘The only limit to our size is finding competent professionals.’ He explains that just being an accountant is no longer enough to do this work—the person has to understand the legal system, and what the law says. How to interrogate and interview people are musts. Tracking leads and obtaining legally usable intelligence is also crucial. ‘Many accountants think it is simply fraud investigation and it’s not. It really is much more than dealing with the numbers. It’s no longer just basic fraud work.’”⁶

Robert Overbaugh, a partner at Pittsburgh-based Sisterson & Co., is more blunt. He asserts that “forensic accounting is often thought of, in somewhat narrow terms, as dealing with the investigations of fraud or financial misconduct.” His firm thinks in broad terms and performs engagements in most areas in which attorneys use

financial experts in litigation and disputes.⁷ To put it another way, a forensic accountant reduces the complexity by distilling information and slicing away deceptions to help a judge or jury to see the essence of a financial dispute.⁸

In a 2014 AICPA survey of international forensic accounting trends, the top services offered were:⁹

Fraud prevention, detection, and response 44% Valuation 37% Economic damages 31% None of the above 29%
Financial statement misrepresentation 27% Family law 16% Electronic data analysis 13% Bankruptcy and insolvency 12%

Of the 443 respondents, 76 percent of the forensic and 54 percent of the valuation practitioners expected growth with most anticipating between 10 percent and 50 percent growth in their practice over the next two years.

Forensic accountants provide perspective in situations evaluating whether accounting information is presented fairly without GAAP-based constraints, such as:

- Identification of financial issues.
- Knowledge of investigating techniques.
- Knowledge of evidence.
- Interpretation of financial information.
- Presentation of finding.¹⁰

James Edwards, the former publisher of the *Journal of Forensic Accounting*, championed this broad definition rather than the narrow fraud examination definition. He believes that forensic accountants are employed to seek, interpret, and communicate transactional and reporting event evidence in an objective, legally sustainable fashion, not only in situations in which there are specific allegations of wrongdoing, but also in situations in which interested parties judge that the risk of loss from wrongdoing is such that proper prudence requires legally sustainable evidence to support the conclusion that no wrongdoing is occurring.

Concisely defined, *forensic accounting* is the use of accounting for legal purposes. Hal Rosenthal gives the modern definition of forensic accounting as “the use of intelligence-gathering techniques and accounting/ business skills to develop information and opinion for use by attorneys involved in civil litigation and give trial testimony if called upon.”¹¹ But in order to establish a context for understanding all the various forensic activities that are associated with forensic accounting today, this book uses a more expansive definition.

Forensic Accounting Services Defined. An AICPA committee says that “forensic accounting services generally involve the application of special skills in accounting, auditing, finance, quantitative methods, certain areas of the law and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings, and may involve either an attest or consulting engagement.”¹²

Forensic

First, for many readers *forensic* may bring to mind a popular academic activity called “forensics” where students from different schools face off in various contests of argumentative and oratorical skill. In fact the term “forensic” refers to items that are used in debate or argument, such as items used in public debate or forum. In commerce or business, things forensic are generally those things that relate to a legal forum or court.

Accounting

Accounting students know that there are many definitions of accounting. For some it is the language of business; for others it is quantifying data for financial purposes—setting up accounts for things. Taken in a broad sense, accounting refers to many activities that relate to financial accounts. Although not all-inclusive, these include identifying, recording, settling, extracting, sorting, reporting, and verifying financial data.

When the terms *accounting* and *forensic* are placed together, however, the sum is greater than its parts. Implicitly, there are a few other factors to incorporate in the definition: time, purpose, and preemptory. **Time**

Most students are familiar with the term *forensic medicine*. Forensic medicine focuses on events that have happened—the cause of illness or death—an analysis of the evidence surrounding trauma that has occurred in the past. Forensic accounting also looks at things past, but it should be noted that some of its most challenging tasks require projections into the future (e.g., valuation, damages). Forensic accountants who value a business, for example, may examine past history, but they often project out in time to look at future cash flows. When a forensic accountant is engaged to determine the monetary loss to a family for harm done to a working mother, he or she may look at past earnings but projects future earnings lost. Forensic accounting focuses on the past, although it may do so in order to look forward. **Purpose**

Purpose also is important. Forensic accounting is accounting performed in some circumstances for a specific legal forum; in other circumstances it is accounting performed in anticipation of presentation before a formal forum. One could argue that all accounting work might presuppose that work performed may be destined for review or argument in a legal forum, but the forensic purpose is more explicit.

Peremptory

Forensic accountants also are engaged in preventing fraud. Just as a physician may recommend certain preventative health measures for healthy patients, the forensic accountant might be called in as a preemptive strike to manage fraud risk. Forensic accountants may be employed in a wide variety of risk management engagements within business enterprises as a matter of right, without the necessity of allegations (e.g., proactive). For example, a forensic accountant may take a preventive approach as a result of normal operations (e.g., review of internal controls or identify areas of fraud exposure). There is no reason to suspect fraud. Second, a forensic accountant may be used to detect indicia of fraud.¹³

Thus, it's possible to construct a good broad working definition for forensic accounting that reflects real-world use of the term.

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.

A Closer Look at Forensic Teams. In 2006, Ernst & Young's (EY's) forensic team was comprised of 350 practitioners in the United States alone and focused on strategies to mitigate and manage conflict in bankruptcy disputes, financial and economic damages, fraud and investigations, government contracts and grants, insurance claims, intellectual assets, and legal technology.¹⁴ Today EY has more than 2,500 (in 2014) team members and more than 100 partners in fraud investigations and dispute services (FIDS) worldwide.

According to Frank Piantidosi, chairman and chief executive of Deloitte Financial Advisory Services (FAS), their "forensic accounting expertise includes antimoney laundering, the Foreign Corrupt Practices Act, purchase price disputes, arbitrations, construction fraud, health care fraud, construction oversight, intellectual property theft, and misdirected royalty revenues, to name just a few."

“We have forensic labs in nine major cities across the U.S. and an additional 20 cities around the world, including Manchester, Hyderabad, Hong Kong, London, Amsterdam, Frankfurt, Cape Town and Melbourne,” he said, adding that all FAS labs meet the FBI’s chain of custody requirements. ‘They are secure, state-of-the-art, and house advanced systems for storing and accessing data, including dedicated servers and fire-resistant safes.’”¹⁵

Distinction between Forensic Audit and Financial Audit

A forensic audit is often different than a typical financial audit. A financial audit is generally a sampling activity that does not look at every transaction. Thus, the system can be exploited by someone, such as an executive, who knows how to “cook the books.”

A forensic audit looks at the detail of a specific aspect of the records, trying to determine why everything does not or should not add up. Thus, a forensic audit is much more time-consuming and can be significantly more expensive than a regular financial audit.¹⁶ Doug Carmichael, former Chief Auditor for PCAOB, faults auditors for not adopting forensic techniques. He prefers more tests of detail rather than relying on tests of controls.¹⁷

Ronald L. Durkin suggests the following differences in a forensic audit versus a traditional audit:

Not limiting the scope of the engagement based upon materiality.

Not accepting sampling as evidence.

Not assuming management has integrity.

Seeking the best legal evidence.

Melding the requirements of the evidential matter standard with the rules of evidence.¹⁸

Two practitioners have suggested these additional procedures may be used in a forensic audit:¹⁹

Extensive use of *interviews* and leveraging techniques designed to elicit sufficient information to prove or disprove a hypothesis.

Document *inspection* that may extend to authentication procedures and handwriting analysis. Significant *public records* search to uncover, for example, unexpected title or ownership, other known addresses, and prior records of individuals.

Legal knowledge regarding *rules of evidence* including chain of custody and preservation of evidence integrity.

Table 1.0 contrasts auditing, forensic accounting, and fraud examination.²⁰

Table 1.0. Contrast Auditing, Forensic Accounting, and Fraud Examination

Characteristic: Audit Fraud Examination Forensic Accounting

Time Perspective:

Primary Focus:

Investigation Scope: Main Work Product is: Main Responsibility to: Guidelines are:

Historical

Periodic

Narrow

Audit Opinion

Company and Public Rules-based

Purpose of Report:

Professional Stance: Ensure GAAP is followed

Non-adversarial Historical

Reactive

Narrow

Fraud Case Report

Defrauded party

Principles-based; under audit rules, it is rules-based

Identify perpetrator of fraud

Adversarial Future and Historical

Proactive and Ongoing

Broad Ranging

Forensic Audit Report

Concerned principal or third party Principles-based

Fraud Risk Assessment and Strategic Services

Adversarial and non-adversarial

A fictional example of a FBI agent illustrates the difference between a financial audit and a forensic audit and how a successful forensic accountant should be perceived.²¹

That was where Holly Johnson's arrival had made things easier. She had the talent. She could look at a balance sheet and just know if anything was wrong with it. It was like she could smell it. She'd sit at her desk and look at the papers, and cock her head slightly to one side, and think. Sometimes, she'd think for hours, but when she stopped thinking, she'd know what the hell was going on. Then she'd explain it all in the case conference. She'd make it all sound easy and logical, like there was no way anybody could be in any kind of doubt about it.

¶ 1011

HISTORICAL ROOTS OF ACCOUNTING

Professor Gary Giroux believes that 10,000 years ago temple priests in Jericho took