

A Broad Approach to Forensic Accounting Is Needed

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In 1986 the AICPA issued Practice Aid 7, which demonstrated the broad scope of forensic accounting. The Practice Aid broke forensic accounting into two general areas, investigative accounting and litigation support. In its graphical description of litigation support services (see Table 1), the Practice Aid showed valuation as one of six categories of services, with four specific services in that category. Accounting was another of the six categories, and fraud was one of the seven services in that category.

The Litigation Services Handbook has six sections comprising 46 chapters, with only one chapter on fraud—specifically tax fraud.¹

Certain groups and individuals have attempted to narrow the scope of forensic accounting so that fraud detection would be the major focus. Valuation, for one, would not be included in this narrowed scope.

We believe that forensic accounting's scope is much broader than fraud detection. Even in the area of fraud, a forensic accountant may be employed in a wide variety

Table 1: Types of Litigation Services

<p>Damages Lost profits Lost value Lost cash flow Lost revenue Extra cost</p>	<p>Valuation Business and professional practices Pension Intangibles Property</p>
<p>Antitrust Analyses Price-fixing Market share, market definition Pricing below cost Dumping and other price discrimination Anti-competition actions Monopolization</p>	<p>General Consulting Actuarial analyses Statistical analyses Projections Industrial engineering Market analyses Computer consulting</p>
<p>Accounting Bankruptcy Tracing Contract cost and claims Regulated industries Frauds (civil and criminal) Historical analyses Family law</p>	<p>Analyses Tax bases Cost allocations Tax treatment of specific transactions</p>

Source: AICPA Practice Aid 7, 1986

1. Roman L. Weil, Michael J. Wagner, and Peter B. Frank, *Litigation Services Handbook*, 3rd Edition, Wiley, NJ, 2001.

of risk management engagements within business enterprises as a matter of right, without the necessity of allegations. In other words, predication is not an absolute step in forensic accounting practice, so that the practice is preventive and proactive. This article will analyze the narrow and broad definitions of forensic accounting.

Tentative Definition

The dictionary defines "forensic" as pertaining to, connected with, or used in courts of law or public discussion and debate.² Hal Rosenthal defines forensic accounting as "the use of intelligence-gathering techniques and accounting and business skills to develop information and opinion for use by attorneys involved in civil litigation, and give trial testimony if called upon."³ 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.⁴ Terry McCarthy, audit partner with Green & Seifter in Syracuse, NY, compares forensic accounting to the TV shows "CSI" and "Law & Order." McCarthy says, "Instead of figuring out the trajectory of a bullet, you're trying to find out how a transaction occurred."⁵

According to James Edwards, publisher of *Journal of Forensic Accounting*, forensic accountants are employed to seek, interpret, and communicate transactional and reporting event evidence in an objective, legally sustainable fashion, not only in situations where there are specific allegations of

wrongdoing, but also in situations where interested parties judge that the risk of loss from wrongdoing is great enough to justify the expense of developing legally sustainable evidence to support the conclusion that no wrongdoing is occurring. This latter type of engagement, known as a preemptory forensic accounting engagement, should not be confused with the more common review of internal controls. Forensic accounting, whether preemptory or after-the-fact engagements, is applied to evidence-of-first-order activities, not secondary systems of controls.

Thus, 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.

Ernst & Young has 350 practitioners in the U.S. who have "significant experience in utilizing accounting, auditing, and investigating skills to assist in legal matters dealing with fraud and other financial business disputes." These practitioners focus 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.⁶

More than Financial Auditing

A financial audit is generally a sampling activity that does not look at every transaction. Thus, the sys-

tem can be exploited by someone, such as an executive, who knows how to "cook the books."

A forensic audit, on the other hand, 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.⁷ Doug Carmichael, former chief auditor for the Public Company Accounting Oversight Board, faults auditors for not adopting forensic techniques. He prefers more tests of detail rather than relying on tests of controls. He encourages more shoe-leather work, which is what forensic accountants do.⁸

The forensic accounting field is broader than fraud auditing, however, because it involves accounting, auditing, and litigation support. In addition to the broader perspective, forensic accounting also requires a different mindset from tax-and-audit accounting. Many accountants are trained that numbers do not lie. Auditing is about following the rules, and auditing professors may not be the appropriate people to teach the forensic course if they are unwilling to develop forensic concepts. Forensic accountants take the opposite tack because they cannot assume books and financial statements are correct. Books may be cooked, financial statements may be deceptively constructed, records may be false, and invoices may be fake. Forensic accountants look beyond the records and invoices. Forensic accountants follow the motto: "Nothing is as it seems."⁹

2. *Random House Webster's College Dictionary*, Random House Reference, New York, 2005.

3. Ask Hal website: www.askhal.com.

4. Terry Carter, "Accounting Gumshoes," *ABA Journal*, American Bar Association, Chicago, September 1997, p. 36.

5. Jeff Stimpson, "Forensic Accounting: Exponential Growth," *WebCPA*, February 1, 2007.

6. Stuart Kahan, "Sherlock Holmes Enters Accounting," *Accounting Today*, May 1, 2006, pg. 1.

7. Jake Poinier, "Fraud Finder," *Future Magazine*, Fall 2004, www.phoenix.edu/students/future/oldissue/winter2004.fraud.htm.

8. Kris Frieswick, "How Audit Must Change," *CFO*, July 2003, p. 48.

9. Motto used by Al Pacino's character in the movie "The Recruit," Touchstone Pictures, 2003.

Barry Mukamal, CPA/ABV, CFE, a partner at Miami-based Rachlin, Cohen & Holtz, says that "forensic accountants untangle events and details that are tangled by design." Andrew Bernstein, CPA, CVA, director of forensic and business valuation services at Miami-based Berkowitz, Dick, Pollack & Brant, says that "you're trying to piece together a puzzle where you don't have the picture on the box to know what it's going to look like. The facts are unsettled, and actually it's the facts that are in dispute."¹⁰

Panel on Audit Effectiveness

Even before Enron, the Public Oversight Board (an independent private sector body created in 1977) appointed the Panel on Audit Effectiveness in 1998 at the request of then-chairman of the SEC, Arthur Levitt, to review and evaluate (a) how independent audits of the financial statements of public companies are performed, and (b) whether recent trends in audit practices served the public interest. The panel conducted the most exhaustive study ever undertaken of the audit model, and on September 6, 2000, released its "Report and Recommendations."

The report's goal was to foster more effective audits that improve the reliability of financial statements, enhance their credibility, contribute to investors' confidence in the profession, and improve the efficiency of the capital markets. Among its most important recommendations is that auditors should perform some "forensic-type" procedures during every audit to enhance the prospects of detecting material financial statement fraud. This new forensic-type phase should become

an integral part of the audit, with careful thought given to how and when to carry out the audit. A forensic-type fieldwork phase does not mean converting a traditional audit to a "fraud audit." Rather, the characterization of this phase of an audit as a forensic-type phase seeks to convey an attitudinal shift in the auditor's degree of skepticism.

The AICPA's position can be summarized as follows:¹¹

- The Institute does not require auditors to carry out specific forensic procedures, but rather provide guidance on how to include forensic techniques within processes outlined in SAS 99. This combination will enhance the detection and prevention of fraudulent financial statement reporting and misappropriation of assets, and thus protect investors and financial statement users.
- Public accounting firms could use forensic accountants to help revise their approach to planning and fieldwork on all audits, while requiring forensic accountants only on high-risk audit clients to aid in the interpretation of forensic testing results and preventive control enhancements.
- The inclusion of audit procedures focused towards detecting misappropriation of corporate assets may lead to the identification of weaknesses within corporate governance or control weaknesses. Frauds that are identified and that represent a material misappropriation of assets could significantly impact public perception.
- Professional forensic accountants can best be used by ensuring such procedures are properly developed and executed in line with internal audit and audit

committee concerns. Forensic accountants could then be engaged in high-risk situations, or when a fraud is suspected.

- Companies should not use the forensic services of their outside audit firm, unless it pertains to the annual audit.
- Putting a price on a substantive test or forensic auditing procedure may be smart for business; however, the inherent risk is that shortcuts geared towards reducing audit costs may eventually cause investors to question the companies' true financial position.

Narrow v. Broad Definition

Many people and universities assume that forensic accounting refers to fraud auditing, specifically fraud examination.¹² Joseph T. Wells, CPA, CFE, the founder and chairman of the Association of Certified Fraud Examiners, indicates that "forensic accounting and fraud examination are different but related. Forensic accounting work is done by accountants in anticipation of litigation and can include fraud, valuation, bankruptcy, and a host of other professional services. Fraud examinations can be conducted by either accountants or non-accountants and refer only to antifraud matters."¹³

In 2002, Wells suggested that "forensic" should not be used to refer to fraud auditing. He believes that forensic accounting is not likely to be understood outside the accounting profession. He stated that "although familiarity with basic accounting concepts is necessary to resolve some cases, the typical accounting fraud doesn't involve much accounting." According to Wells, "little is to be gained and much is to be lost by trying to foist 'forensic accounting'

10. Jeff Stimpson, "Forensic Accounting: Exponential Growth," WebCPA, February 1, 2007. Available at www.webcpa.com/article.cfm?articleid=23165&pg=pracacc.

11. AICPA, Discussion Memo Question Responses.

12. The Association of Certified Fraud Examiners in Austin, Texas, offers professors free videos and other materials if they will title their fraud or forensic courses "Fraud Examination."

13. Joseph T. Wells, "The Fraud Examiner," *Journal of Accountancy*, October 2003.

14. Joseph T. Wells, "The F-Word by Another Name," *Fraud Magazine*, ACFE, October 2003.

off on an increasingly skeptic public that already views much of accounting as smoke and mirrors. Whatever expectation gap already exists can only be widened by wordplay.¹⁴

James Edwards, *JFA* publisher, champions a broader definition of forensic accounting. He believes that it is all about evidence; forensic accounting should not be defined by fraud investigation. The focus of *JFA* is on the evidentiary nature of accounting data, and topics include accounting fraud and fraud auditing; compliance, due diligence, and risk assessment; detection of financial statement misrepresentation and tax evasion; bankruptcy and valuation studies; GAAS, GAAP, and SEC violations; non-standard entries, structures transactions, records tampering, and earnings management (non-neutral financial reporting); fair presentation and disclosure transparency; audit quality review and evaluation; transaction tracing, reconstruction, and accountability; litigation support and dispute avoidance; extended procedures within a statutory audit environment; money and information laundering; and the underground economy.

As an example, Frank Piantodosi, chairman and chief executive of Deloitte Financial Advisory Services, says that his firm's forensic accounting expertise includes anti-money 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 areas.

Deloitte has forensic labs in nine major cities across the USA and 18 other cities around the world, including Hong Kong, London, Amsterdam, Frankfurt, Cape Town, and Melbourne. 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," he says.¹⁵

Bruce Dubinsky, CPA, CVA, CFE, president of Dubinsky & Company in Bethesda, MD, advocates a broad definition. "Just being an accountant is no longer enough to do this work," he says. "The person has to understand the legal system and the law. 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."¹⁶

Edwards believes that the ultimate goal of a forensic accountant is to communicate an analysis of evidence of economic transactions and reporting events, structured within some legal framework, so that it is understood and accepted as fact with "scientific certainty"; that is, to present "a legally accurate accounting." Thus, forensic accounting can be both adversarial and collaborative. Adversarial application could occur in bankruptcy, fraud, business disputes, or divorce. The level of evidentiary detail and precision sustainable in an adversarial legal proceeding may also be applied in "collaborative" assurance engagements such as due diligence reviews, business valuations, audit committee advisory services, and enterprise risk management.

Robert Overbaugh, CPA, CVA, a partner at Pittsburgh-based Sistrer & Co., is blunter. He says that "forensic accounting is often thought of, in somewhat narrow terms, as dealing with the investi-

gations of fraud or financial misconduct. We think of forensic accounting in broader terms, and perform engagements in most areas in which attorneys use financial experts in litigation and disputes."¹⁷

DOJ Model Program

Regrettably, West Virginia University used a \$600,000 Department of Justice grant to develop a narrow "model curriculum" for training university students in fraud and forensic accounting. In fact, the December 20, 2005, exposure draft is an investigative curriculum and not a forensic curriculum. For example, the exposure draft gives nine "Model Curriculum Working Definitions," and eight of the nine involve fraud. The report does define forensic accounting as "the application of accounting principles, theories and discipline to facts or hypotheses at issue in a legal dispute and encompasses every branch of accounting knowledge."¹⁸ There are no definitions for valuation, damages, lost profits, lost value, litigation services, and so on.

A graphic provided in the report (See Figure 1, pg. 18) demonstrates the narrow approach taken, and one wonders how a 14-member planning panel could have accepted such a graphic. The report states that the "level of overlap between forensic accounting and fraud may be larger than depicted here." At least four of the 14 members of the planning panel were CFEs, and there were no representative Cr.FAs, CFDs, CFFAs, CVAs, or CFSs.

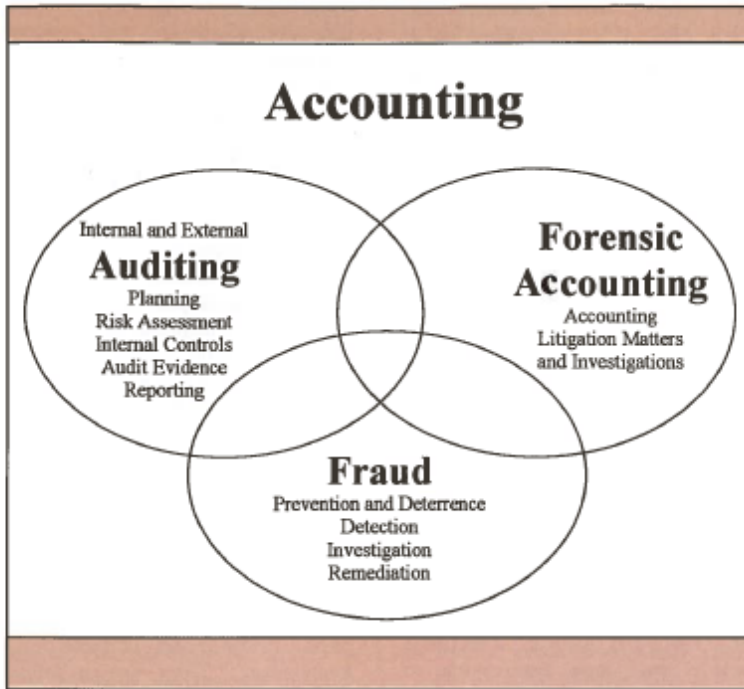
Although one may argue as to how small the fraud circle should be with respect to items such as valuation, damages, bankruptcy, family law, general consulting, analyses, anti-trust analyses (some of the 31 categories in the

15. Stuart Kahan, "Sherlock Holmes Enters Accounting," *WebCPA*, May 1, 2006.

16. *Ibid.*
17. *Ibid.*

18. U.S. Dept. of Justice, Education and Training in Fraud and Forensic Accounting: A Guide for Educational Institutions, Stakeholder Organizations, Faculty and Students, Exposure Draft, December 23, 2005, p. 6.

Figure 1: West Virginia University Model Curriculum¹⁹



1986 AICPA Practice Aid No. 7), a corrective graphic should appear somewhat as shown in Figure 2.

The shaded area in Figure 2 is forensic accounting, and fraud is a small part of forensic accounting. Kevin Flaherty, CPA, CVA, a partner in the Boston office of Matson, Driscoll & Damico, indicates that a forensic accountant helps identify and locate the information needed to build or bolster either side of a dispute. Financial statements are often prepared under GAAP guidelines, which may not be appropriate for a legal dispute. "A qualified accountant is also prepared to deal with the intricate legal system, through his or her awareness of the differences between an expert and consultant, familiarity with appropriate file maintenance, understanding of the distinction between deposition testimony vs. trial testimony, and willingness to meet key deadlines."²⁰

Figure 2: A Suggested Broad Approach

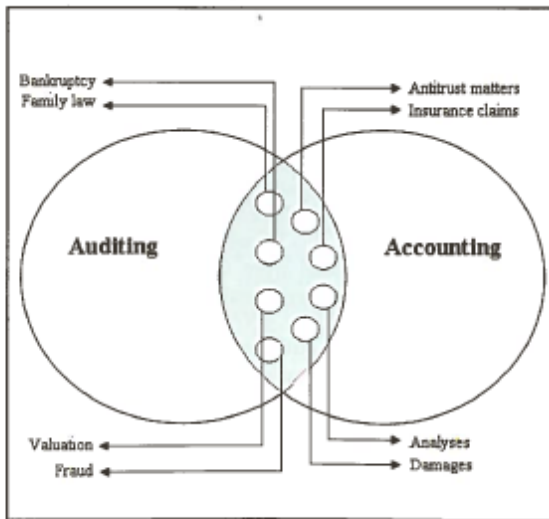
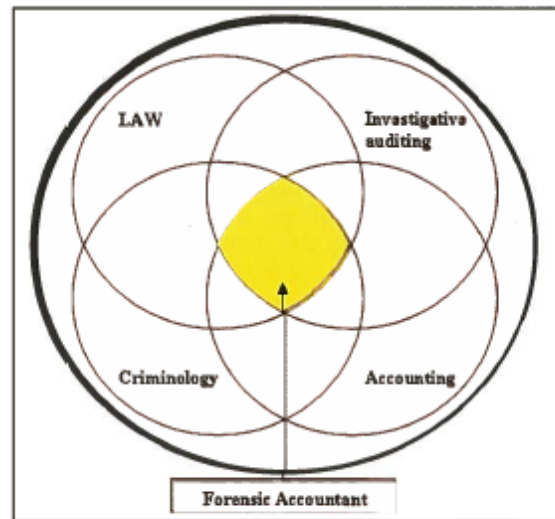


Figure 3: Forensic Accounting Knowledge Base



19. Ibid, page 5.

20. Kevin Flaherty, "Defense by the Numbers: Adding a Forensic Accountant to Your Team," *For the Defense*, April 2005, DRI

Figure 3 provides a better representation of the broad definition of forensic accounting.

A fifth circle of computer technology could be added to be more complete. Bruce Dubinsky says, "Statistics indicate that 92 percent of new data is created electronically, and that 70 percent of [those] data never migrate to paper." In any case, the middle shaded area is forensic accounting.

The West Virginia Model Curriculum group apparently wanted to release a fraud curriculum, but they decided to insert the term forensic accounting because of its high visibility and excitement (e.g., the "CSI" phenomenon). Three of their four so-called forensic courses involve fraud. One can argue that some of the material covered in these four courses are already covered or should be covered in the auditing courses. As it now stands, the curriculum proposal is to a certain extent a fraud. To a certain extent it is a curriculum to sell some narrowly focused textbooks on fraud examination.

In the WVU Model Curriculum graphic (Figure 1), the "Core Fraud and Forensic Accounting" suggested course is thin. The Model Curriculum seems to spread the fraud material over three courses when one course would have been sufficient. On page 47 of the October 31 draft report, under "Instructor Experience," they seem to suggest that faculty who are uncomfortable because they have little experience in fraud and/or forensic accounting should get outside accountants to come into the classrooms and teach. They recommend the ACFE material. The report seems to be saying that auditing teachers who wish to teach forensic accounting do not have to make a lot of effort to learn

the material. Just bring in outside experts, and you do not have to be thoroughly familiar with the topics. Since academics who teach auditing are more comfortable with fraud, the report gives professors a way out of a broader definition of forensic accounting.

A number of colleges and universities are offering three or four fraud courses with little or no coverage of the other important and exciting areas of forensic accounting (e.g., valuation and damages). They spread the fraud material over several courses and thereby devalue the classroom hours. We argue that a broad-based forensic accounting course is more appropriate. Such a course can be found at www.bus.lsu.edu/accounting/faculty/lcrumbley/Acct7235-Spring2007.pdf.

Conclusion

Forensic accounting certainly is a hot subject, as indicated by a recent remark by Gordon Brown, Chancellor of the Exchequer, on October 10, 2006. He said, "What the use of fingerprints was to the 19th century and DNA analysis was to the 20th, forensic accounting will be to the 21st century."

The battle will continue to be waged between the powerful groups and people who wish a narrow definition versus a broad definition. But as D.W. Squires says, "Economic crimes and fraud often do not involve obvious, smoking-gun evidence." Forensic accountants "look behind the deals and handshakes and probe beyond the numbers to uncover the reality of financial situations." Evidence, of course, is the key and should be stressed in forensic accounting classes. A British publication suggests that prosecutors think that accountants have

x-ray vision: "It is assumed that if an accountant stares really hard at a set of accounts, then somehow, magically, information will appear before his/her eyes that are invisible to lesser mortals."

Of course, the task of fighting accounting fraud may be like Sisyphus, condemned to roll a rock up a hill each day only to watch it roll back down again. More vigilant internal and external accountants with forensic accounting training can make great strides in decreasing fraud. **NE**



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21. Stuart Kahan, op. cit.

22. D. W. Squires, "Problems Solved with Forensic Accounting: A Legal Perspective," *Journal of Forensic Accounting*, Vol. IV (2003), p. 131.

23. *NIFA News*, Number 10, p. 1.