



Forensic Accounting to the Forefront

It was a growing specialty before Enron, WorldCom, and Sarbanes-Oxley. Now, it's really hot.

by *Howard W. Wolosky*

"Years ago, I told somebody we were forensic accountants and they thought we looked at dead bodies. We don't get that type of comments any longer," observes Cal Klausner, managing partner of Klausner Dubinsky + Associates, in Bethesda, Md., which specializes in forensic accounting.

The fallout from Enron and WorldCom pushed fraudulent financial statements to the front pages. But even without those huge debacles, fraud is quite pervasive. The Association of Certified Fraud Examiners, in its second Report to the Nation on Occupational Fraud and Abuse, released in 2002, estimates that six percent of revenues is lost as a result of fraud. This translates to losses of approximately \$600 billion.

According to the report, small businesses are the most vulnerable, averaging \$127,500 in losses, and the typical perpetrator is a first-time offender. Fraudulent financial statements are the most costly, at median losses of \$4.25 million per scheme. Losses caused by perpetrators older than 60 are 27 times higher than losses caused by employees 25 and younger and the average fraud scheme lasts 18 months before it is detected. On a positive note, companies with fraud hotlines cut their fraud losses by approximately 50 percent per scheme.

Growing Problem?

Joseph Wells, chair of the Board of Directors for the Association of Certified Fraud Examiners (ACFE), attributes the hot status of forensic accounting to the litigation environment, the wave of accounting fraud, increasing public expectations, and an awareness on the part of CPAs that they can profit by offering fraud-related services.

Larry Crumbley, Editor-in-Chief of the Journal of Forensic Accounting, and KPMG Professor of Accounting at Louisiana State University, feels there is a marked increase in fraud. He points out there is less loyalty from mobile workers, and an overall change in society including the break-up of the family unit and people becoming less religious and less ethical.

Sherlyn Farrell, CEO of the worldwide firm of RGL-Forensic Accountants and Consultants, headquartered in Englewood, Colo., also believes the amount of fraud has increased. "Corporate America in the 1990s implemented stock option compensation plans. The thought was to put management compensation more in alignment with shareholders, but the execution, the abuse of it, and the personal greed was a downside. Then you had the dot.com boom, with traditional companies competing with dot.com companies trying to make themselves look as good."

Robert J. DiPasquale, partner with the Business Investigation Services Group, in the Parsippany, N.J., office of regional accounting firm J.H. Cohn, thinks it's not so much an increase in fraud as a change in perception. "I think that it is more public perception over the last couple of years. Forensic accounting itself probably as a term of art has been in existence for 15 or 20 years. But it is the notoriety with Enron and WorldCom, where it hurt the pocketbooks of the working class where their retirement and ability to make a living were destroyed, that got the public eye as to what we are doing. Also, the forensic accountant hit the paper in the O.J. Simpson case in terms of tracking his assets."

A recent survey by KPMG seems to support that conclusion, according to Richard Girgenti, national partner in charge of KPMG's Forensic Practice. The results of the 2003 Fraud Survey indicate that 75 percent of respondents report they uncovered fraud in the last year, compared with 62 percent in a 1998 survey. Girgenti believes that there is not necessarily more fraud. "I think it is a heightened sensitivity to what probably was going on all along," he opines.

Runs the Gamut

So what is forensic accounting? According to Wells, "typically, it relates to any accounting for courtroom purposes, such as valuation, divorce, bankruptcy, fraud, or business disputes. DiPasquale adds accounting malpractice, legal malpractice, arson investigations, and the tracing of assets.

L. Horton & Associates, a Kingston, R.I., firm that only does forensic accounting, shows you don't have to be a big firm in this field. Owner Lorraine Horton says she has relationships with other experts, such as a firm that does a lot of municipal and public accounting, a private detective, and experts in internal audits and technology. She brings them in on a project basis. Horton adds, "Everybody that does forensic accounting has a different specialty. I do a lot of data reconstruction, data mining, and work with municipal governments."

Her firm always charges an hourly rate. "Forensic accounting is very different from auditing in that there is no template to use. There are no set rules. You don't know when you go into a job how it is going to be," she notes.

Auditing vs. Investigative Accounting

"There is a significant difference between auditing and forensic accounting," says Lorraine Horton, owner of L. Horton & Associates in Kingston, R.I. "Auditing is governed by materiality. In investigative accounting, it is the opposite. I am looking for one transaction that will be the key. The one transaction that is a little different, no matter how small the difference, and that will open the door," she explains. Discovery of that seemingly immaterial loss is vital. Robert J. DiPasquale, partner with the Business Investigation Services Group, in the Parsippany, N.J., office of regional accounting firm J.H. Cohn, points out that fraud usually starts slowly. "It begins with little amounts because the perpetrator is going to test the system. If they get away with it, then they keep on increasing and increasing it," he notes.

Derk Rasmussen, director of Litigation Support and Business Valuation for, and partner in, RGL-Forensic Accountants and Consultants, at their Salt Lake City, Utah, office, believes it is difficult for a small firm that wants to develop a forensic accounting specialty. In analyzing the “build” vs. “buy” mentalities, he sees buy as winning out.

Wells sees cash reviews as an excellent revenue opportunity with regard to smaller companies. “CPAs can do a cash review of receipts and disbursements, as most internal fraud occurs in cash accounts. This is especially important if one person is doing the bookkeeping,” he concludes. A little client education might be needed. “It’s up to the CPA to convince that client that the trusted bookkeeper is exactly the one that he has to worry about. You must educate that client about fraud and the areas of vulnerabilities and that it is not necessarily a bad or evil person who commits fraud.”

KPMG has been doing this type of work for years, usually after fraud has been detected and KPMG helps the client establish a system that will better detect fraud. The idea, according to Girgenti, is to create a new culture. “We work very closely with audit committees and management to build up their fraud awareness. We also talk about the leading practices that an organization should have. That could be a code of conduct, and helping the audit committee understand its oversight responsibilities.”

DiPasquale cautions firms considering forensic accounting. “It is a very competitive field. What is interesting is that you may be a good accountant, but not a good forensic accountant. The training and the way you look at transactions is different.” Another potential problem is that, unlike auditing, lower-level staff often can’t be used for an engagement. Horton believes they normally won’t spot anything out of the ordinary, and she adds that “an experienced person should be the one testifying as well as doing the investigative work.”

A Tool, and an Added Threat

Bert Lacativo, Chair of the AICPA Fraud Task Force and managing director of FTI Consulting at their Southlake, Texas, office, believes extensive knowledge and use of technology is an absolute necessity. He cites the ability to go in an electronic image and download information, and to get information from systems that don’t talk to each other. He explains that all the accumulated information can then be reviewed for financial improprieties.

“We use off-the-shelf software (IDEA) to import large databases, read different data files, set up queries, and compare database files such as addresses, telephone numbers, and Social Security numbers,” says Klausner. “This will tell us, for example, if a purchase order was done on Saturday or Sunday when the company isn’t open.”

Wells identifies five areas where he sees technology being actively used. They are fraud case management, financial statement analysis, transaction analysis, data mining, and hard-drive scanners.

Technology also increases the chance of fraud, according to Wells, as approvals become automated, and someone with knowledge of the system can commit fraud if adequate internal controls aren’t in place. Identity and information theft is also much more rampant.

DiPasquale believes the trend of going paperless hinders a CPA’s ability to find fraud. For instance, he points out that many banks are no longer sending out cancelled checks.

Klausner recounts how technology was used to commit fraud in selling pools of credit card debt. A cooked formula was embedded in software by the seller of the debt to analyze the quality of debt for the purchaser, so no matter what debt came out, it had a good collection ratio, and the purchaser was willing to pay more. Only by analyzing the software coding was the fraud discovered.

Getting the Engagement

Horton indicates most of her work comes from word of mouth, municipalities’ offers for bids in newspapers, and lawyers that the firm worked with previously. Klausner Dubinsky + Associates gets most of its work through lawyers and is generally hired by the law firm rather than the business against which the fraud was committed. Klausner says this is preferred, so his firm will be protected by the attorney/client privilege.

Getting your name out there in a highly publicized case also helps, suggests Klausner. His firm has also set up a booth at a local bar association meeting, and at a crime summit in Virginia. DiPasquale lectures to law firms, business owners, internal auditors, and accountants. He normally speaks on how financial statements are manipulated, or how fraud is perpetrated.

Farrell believes it is important to work for both sides—plaintiffs and defendants, prosecutors and criminal defense lawyers—as this helps establish credibility on the witness stand.

Impacting Audits and Beyond

“The accounting profession has traditionally tried to avoid using the fraud word up until SAS 82. They didn’t even call it fraud, they called it ‘irregularities’, like a high-fiber diet was a cure for that,” says Wells. The successor to SAS 82, SAS 99, which is now just beginning to have application with regard to audited financial statements, prescribes specific steps regarding detection of material misstatements due to fraud.

They include pre-audit brainstorming, increased professional skepticism, additional inquires, consideration of fraud risk factors, a determination of the response to the risk factors, and extensive documentation. Wells believes SAS 99 is unique in that it says that there is a risk of fraud in every business, and auditors must ask, “If this particular client was to commit fraud, where would it typically be?”

SAS 99 will require firms to evaluate audit staff to see if they have the necessary background. If a staff doesn’t have the necessary fraud expertise, it will have to be developed. “Most accountants are used to following an audit plan. They are not trained to think like forensic accountants, and that is a problem because they are now called upon to use a skill set that many of them don’t possess. Many of the partners and managers have to be retrained to approach things differently, with more of a business entrepreneurial view, not just a compliance view,” Rasmussen concludes.

Ask the Right Person the Right Questions

Lorraine Horton, owner of L. Horton & Associates in Kingston, R.I., says that in her engagements, she typically examines the internal controls. But what she finds most valuable is the personal interaction. "Someone knows what is going on. If you tune in, you will get a feel for it," she says.

Robert J. DiPasquale, partner with the Business Investigation Services Group in the Parsippany, N.J., office of regional accounting firm J.H. Cohn, believes it is important that you select the right person to interview, and be conversant in interviewing techniques. For instance, he suggests picking someone from customer complaints or an employee who didn't get a raise for two years, as they would be likely to provide the needed information.

Crumbley reports the national accounting firms are adding forensic specialists, requiring thousands of hours of fraud training, adding intensive instructions on internal controls, identifying high-risk clients and then adding forensic specialists to the audits of those companies, and acquiring software for quantitative analysis. He adds, for some audits, smaller firms might have to hire outside experts.

DiPasquale believes that accountants must be attuned to detecting fraud at every level of service, including standard accounting services, compilations, reviews, and bank reconciliations. His reasoning is that if there is fraud and you don't detect it, you are going to be sued and you will likely lose, as the public perception is the accountant is the watchdog.

Profession's Responses

Accountants are getting increased support both in terms of assistance in forensic accounting, and the role of fraud detection in regard to

traditional accounting and auditing work.

The Association of Certified Fraud Examiners, which offers the Certified Fraud Examiner certification, now has nearly 30,000 members in 120 countries, and 60 percent have an accounting background. One-third are CPAs. The basic qualifications for the CFE are a baccalaureate degree, two years' fraud-related experience (auditing, but not tax, counts as "fraud-related"), and the passing of a computerized exam.

There are a number of joint ACFE/AICPA initiatives, including a one-hour presentation for the public titled, "How Fraud Hurts You and Your Organization," and "Fraud and the CPA" for firms, a 20-hour self study course on how fraud is committed. The ACFE and AICPA also launched the Institute for Fraud Studies under the auspices of the University of Texas. According to Wells, "It will take a broad-based look at fraud, not just from an accounting perspective, but from personal, sociological, criminological, and legal perspectives and try to identify in an organization what would be best practices to prevent fraud." The ACFE is following a similar approach in Europe, where it established the European Council on Occupational Fraud.

Other AICPA efforts include:

- The AICPA's Board of Directors approved the conversion of the Consulting Services Membership Section into the Business Valuation/Forensic & Litigation Services Membership Section;
- An Anti-Fraud Resource Center;
- A close working relationship with the FBI has been established;
- Two online interactive assessment competency tools, one for business valuation, forensic accounting, and litigation services, and the other for fraud; and
- Consulting Services Special Report 03-1, Litigation Services and Applicable Professional Standards has been released. It provides guidance for CPAs performing forensic and litigation services engagements.

Jim Feldman, manager of Business Valuation and Forensic and Litigation Services with the AICPA, also indicates that the Institute has released an SAS 99 implementation guide, and will be soon publishing a new practice aid on engagement letters.

There are also more certifications, in addition to CFE, being offered to CPAs. Two from the National Association of Certified Valuation Analysts are the Certified Forensic Financial Analyst and the Certified Fraud Deterrence Analyst. The first is aimed at CPAs performing litigation support engagements, and the second at those interested in fraud prevention. Parnell Black, CEO of the National Association of Certified Valuation Analysts, sees the Certified Fraud Deterrence Analyst as unique, providing clients the assurance that CPAs are qualified to help them in preventing fraud.

Colleges are also focusing on fraud. Wells points out that 19 out of 900 colleges offered a fraud course three years ago, and now the number is about 300. The ACFE's Higher Education Initiative provides free resources to colleges offering a fraud examination course.

Need to View Things Differently

The first question that Klausner is usually asked after finishing a forensic accounting engagement is: "Should we sue the accountant?" In one case, he indicates an accounting firm gave clean opinions for nine consecutive years to a company even though it was later discovered fraud was being committed during all that time. He concludes, "If SAS 99 was in effect then, the ability to recover from that firm would have been greater."

If accountants fail to detect fraud, even if they followed all the required procedures, it can become a liability issue for them. Additionally, Wells explains that fraud is not just an accounting issue. "It is a sociological phenomenon, and it can't be solved entirely through the application of internal controls and accounting techniques. We need to take a more holistic look." His ultimate solution is the development of model fraud-prevention programs, and having accountants test a company's compliance.

"Fraud is very hard to find, and society has not been willing to pay accountants to find it," says Crumbley. With fees going up for audits and the increase in forensic accounting engagements, maybe everybody is beginning to understand the CPA is not someone to blame, but an ally in combating fraud.

February 2004