


FORENSIC ACCOUNTANTS

Hot Old Profession

BY DOUGLAS E. ZIEGENFUSS



The recent accounting scandals involving Enron, WorldCom, and other companies have put accountants in the public spotlight as never before in their history. For several months in early 2002, the media treated Americans to accountants giving Congressional testimony or making court appearances. However, so-called “forensic accountants” have been conducting these activities for quite some time in a quiet professional manner. New laws and regulations resulting from the scandals will make the role of the “forensic accountant” more important than ever before in today’s business world.

Simply put, forensic accounting includes any accounting engagement in support of a legal case. The word “forensic” has an exotic connotation but is really a very basic concept. For instance, forensic medicine is medicine that supports court cases. Although forensic accountants don’t examine anything as exciting as dead bodies like the medical examiner in a Patricia Cornwell novel, they do arrive to find the charred remains of companies that have been totally looted of their assets like the Adelphia Communications Company was in 2002. Still other forensic accountants may testify on the worth of a company in a heated court case dealing with a bitter divorce or a contested will. In other words, forensic accountants do get their fair share of excitement and thrills.

Types of

Forensic Searches

Forensic accounting engagements usually involve business valuations or fraud examination. Both types of forensic accounting have been around for a long time. Business valuation experts are usually involved whenever the ownership of an organization changes or a business disruption occurs. Otto Martinson, a professor of accounting at Old Dominion, specializes in business valuation services. He has negotiated the sale of several companies, performed research on valuing employee-owned businesses, and created a course on business valuation services. Divorces, particularly messy ones, require the use of business evaluation experts, as well as individuals who know where to look to uncover assets that one party in the divorce does not want the other party to discover.

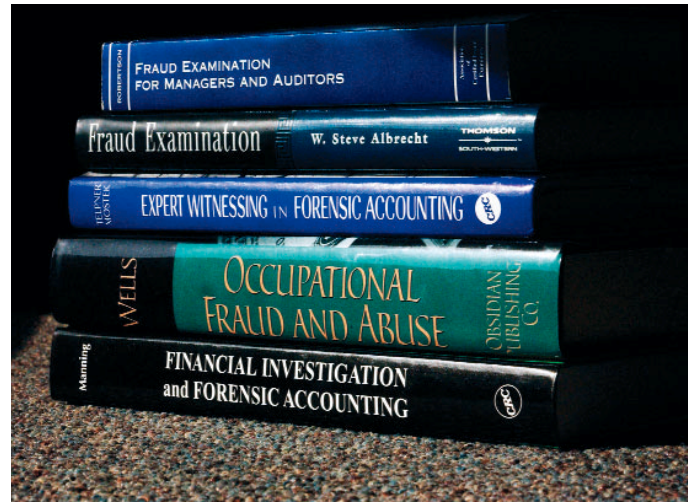
Fraud examination was given a strong boost with the adoption of the federal income tax in the early part of the 20th century. Forensic accountants sent the gangster Al Capone to jail for income tax evasion. Organizations usually employ fraud examiners directly or hire independent experts. In addition, many traditional auditors have adopted forensic accounting techniques during the review of their clients' accounting records. I have performed forensic accounting engagements and conducted research in forensic accounting for more than two decades. The remainder of this article deals

with the fraud examination aspect of forensic accounting, since that is the area currently receiving the most public attention.

The Association of Certified Fraud Examiners (ACFE) is the professional organization for fraud examiners. Located in Austin, Texas, the ACFE was founded by an ex-FBI agent, John Wells, in the mid-1980s. The ACFE has developed extensive training materials, a code of ethics and professional standards and the Certified Fraud Examiner designation. It has consistently lobbied accounting standard-setting bodies for more rigorous anti-fraud measures. Information about the ACFE can be found on its Web site: www.cfenet.com.

Fraud Examiner on the Case

The typical fraud examination involves four phases: planning, fieldwork, assessment and reporting. These phases differ depending on whether an actual fraud has occurred. For instance, fraud examiners are frequently called on to review an organization's policies and procedures to identify potential weaknesses that could allow fraud to occur. The fraud examiner in these types of engagements obtains an understanding



of the policies and procedures by examining manuals, interviewing personnel and observing the various procedures. The fraud examiner then identifies strengths and weaknesses in the procedures. In addition, the examiner actually tests whether the policies and procedures are being followed. Finally, the fraud examiner submits a report identifying and describing the unforeseen weaknesses and the policies or procedures that are not being followed or performed.

Most organizations do not have the foresight to implement adequate controls until they become fraud victims. In these instances, the victimized organization consults a fraud

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examiner to identify the perpetrator(s) and attempt to recover damages. The fraud examiner must function as a detective in

examining the scene of the crime, interviewing suspects, and obtaining confessions. The fraud examiner works with the organization's counsel to build a winnable case. This is a very valuable service because the courts are severely overburdened with drug cases. Prosecutors will not pursue a case if the loss does not meet certain thresholds, or the case requires too much preparation on their part. Fraud examiners can help their organizations by producing complete case files that require a minimum of follow-up effort by prosecutors. In addition to a thorough knowledge of accounting and auditing, fraud experts need a solid background in law, criminology, and fraud techniques such as interviewing and interrogation. Most of these skills are acquired through training or on-the-job experience. However, Old Dominion University's Department of Accounting recently added a course titled "Fraud Examination and Forensic Accounting" to its graduate curriculum. I developed and taught the first offering of this course during the fall 2002 semester.

A Theft or Just Inept?

Fraud is currently classified as either fraudulent financial reporting or misappropriation of assets. Fraudulent financial reporting involves the use of misleading financial statements to deceive investors and creditors. It happens relatively infrequently, but when it does occur, it can have catastrophic effects, as evidenced by the recent scandals involving Enron, WorldCom, etc. When employees at the CEO/CFO level carry out fraudulent financial reporting, they pressure the organization's accountants to compromise their professional ethics and produce misleading financial statements. The existence of stock options and other forms of compensation tied to the organization's financial results are often cited as the motivation for executives to engage in fraudulent financial reporting.

On the other hand, lower level employees usually misappropriate assets. This type of fraud occurs more frequently but usually involves lower losses than fraudulent financial reporting frauds. In most instances, employees misappropriate assets because supervision is lax, and perpetrators are given too many conflicting jobs to the point that they can steal assets and conceal the theft.

Researchers in fraud examination initially focused on defining the magnitude of the fraud problem. In 1997, the ACFE released the first truly national study of fraud, titled "Occupational Fraud and Abuse," and completed a follow-up study in 2002. Taken together the two studies go a long way to document the enormous impact that fraud has on our economy. For instance, the ACFE estimates that organizations lose approximately 6 percent of their revenues to fraud. If this figure is multiplied by the U.S. Gross Domestic Product, then the total economic impact of fraud is approximately \$400 billion per year! Numerous other studies have also documented the enormity of the fraud problem. I conducted a study of fraud in cities and counties, which indicated embezzlement or theft of cash to be the most frequent type of fraud, followed closely by false invoices and contract fraud. In addition, I found that the government entity's ethical environment was a key factor in limiting the occurrence of fraud. I also received an interesting survey result in which the original respondent did not reply because he had been sent to prison for embezzlement!

Fraud researchers have also attempted to identify factors that cause or allow fraud to occur. Donald R. Cressey hypothesized that three factors needed to be present for fraud to occur: pressure on the perpetrator (drug addiction, stock options, excessive ego, and lifestyle, etc.); perceived opportunity (lack of supervision and controls); and rationalization ("Everyone else is doing it," "The company owes it to me," or "I am just borrowing this money and plan to repay it when

FRAUD PREVENTION TIPS

FRAUDULENT FINANCIAL REPORTING

- Know the company in which you invest.
- Be cautious of companies that rely on estimates for much of their revenue, or that have several years in which they report accounting earnings yet have negative cash flows from operations.
- Be cautious of companies that rely on complex and unexplainable transactions.
- Review the company's board of directors and its audit and compensation committee.
- Be cautious of companies whose officer compensation relies too much on stock options.

MISALLOCATION OF ASSETS

- Understand that your organization can be the victim of fraud just like other organizations and that your co-worker may be a perpetrator.
- Understand your company's basic business transactions to the point that you can spot transactions that don't make sense. Thoroughly investigate all unusual transactions.
- Don't trust documentation or the form of the transaction. Determine the true substance of the transaction.
- Have a company code of ethics and a fraud hotline or other system for reporting fraud.
- Ensure that supervision is effectively performed.
- Don't give an employee the opportunity to steal assets and then conceal the theft.
- Rotate duties and enforce vacations.
- Have regular audits on a surprise basis of areas that are not traditionally audited.
- Review your company's vendor and customer lists for fake vendors or customers.
- Investigate suspicious transactions.
- Finally, know your employees and investigate changes in lifestyle or swings in mood and behavior.

things improve.”). Recent studies have corroborated Cressey’s theories at least as far as asset misappropriation is concerned.

Management Controls

Reduce Fraud

The Treadway Commission in the 1980s studied the causes of fraudulent financial reporting and found that the No. 1 deterrent of fraudulent financial reporting was the “Tone at the Top,” or management’s attitudes toward controls. If management took a serious interest in ensuring that adequate controls were present and operating in their organizations, then fraudulent financial reporting did not occur. However, as with Enron and others, if management did not take an interest or purposefully ignored controls, then fraudulent financial reporting inevitably occurred. Other studies

and the recent scandals have corroborated the Treadway Commission’s findings.

My colleagues in the College of Business and Public Administration and I have also focused our research on the importance of professional codes of conduct to ethical decision-making by involving internal auditors, management accountants and fraud examiners. In general, our research indicates that membership in professional societies with codes of ethics may improve ethical decision-making and indirectly reduce fraud by taking away the rationality that perpetrators use to justify their crimes.

Unfortunately, nearly all the studies point to increases in the frequency and amount of frauds. It is hoped that the measures taken last summer by Congress, the Securities and Exchange Commission, and the major stock exchanges will focus the public’s attention on the fraud problem and reverse this upward trend.



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