The Expanding Role of the Forensic Accountant

By D. Larry Crumbley, PhD, CPA, CFD, Certified Forensic Accountant (Cr.FA), and Diplomate of the American Board of Forensic Accounting, and Nicholas G. Apostolou, DBA, CPA, Certified Forensic Accountant (Cr.FA), and Diplomate of the American Board of Forensic Accounting

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Abstract
The Sarbanes-Oxley Act (SOX), the Statement on Auditing Standards–99 (SAS 99), and the Public Company Accounting Oversight Board (PCAOB) have not removed the pressures on CFOs to manipulate accounting statements. The PCAOB recommends that an auditor should perform at least one walkthrough for each major class of transactions. SAS 99 does not require the use of forensic specialists but does recommend brainstorming, increased professional skepticism, and unpredictable audit tests. A proactive fraud approach involves a review of internal controls and the identification of the areas most subject to fraud. Certified Forensic Accountants, Cr.FAs, will continue to be in demand to supplement the efforts of internal and external auditors.

In March 2005, Bernard Ebbers, the former CEO of WorldCom, was convicted on nine counts of fraud including securities fraud, filing false reports, and conspiracy. Although this case was treated by the press as a singular event, convictions for corporate fraud are much more widespread than many realize. On March 22, 2005, The Wall Street Journal reported that from 1978-2002, federal regulators initiated 585 enforcement actions for financial misrepresentation by publicly traded companies, citing 2,310 individuals and 657 firms as being potentially liable.

Clearly, internal and external auditors must utilize more fraud detection and forensic techniques into their audit programs. If fraud is suspected and the auditors have no forensic accountants on staff, a Certified Forensic Accountant, Cr.FA, should be consulted.

Enron and WorldCom Events
A number of fraud discoveries shook public confidence in our system of checks and balances designed to protect the interests of shareholders, creditors, and other beneficiaries of public companies. The public and policymakers were galvanized in October of 2001 when Enron, then the nation’s seventh largest company, revealed more than $1 billion of accounting errors that stunned investors and launched investigations that continue today. Since then, dozens of companies have been prosecuted or investigated for financial fraud, including WorldCom, which was responsible for the largest instance of accounting fraud as well as the largest bankruptcy in history.

WorldCom was one of the main contributors to the 2000-2002 slide in world markets that knocked hundreds of billions of dollars off the value of stocks and shook Wall Street to its foundations. Its external auditor was Arthur Andersen, also the auditor of Enron. Apparently, Andersen was given limited access to the general ledger of WorldCom, which is a violation of basic auditing standards. Forensic accountants cannot rely on the works of internal and external auditors.

WorldCom improperly accounted for $11 billion. An example of its duplicitous practices was WorldCom’s accounting for online costs. Most of the original entries for online costs were properly placed into expense accounts. However, near the end of the accounting period these entries were reversed. One such entry was as follows:

| Other Long-term Assets | $629,000,000 |
| Construction in Progress | $142,000,000 |
| Operating Line Costs | $771,000,000 |

The support for this entry was a yellow sticky-note. When questioned by the internal auditing staff, the outside auditors...
Coopers has defined fraud as a “broad concept that refers generally to any intentional act committed to secure an unfair or unlawful gain.” Michael Comer divided fraud into the following types:

- Corruptions (e.g., kickbacks)
- Conflicts of interest (e.g., drug/alcohol abuse, part-time work)
- Theft of assets
- False reporting or falsifying performance (e.g., false accounts, manipulating financial results)
- Technological abuse (e.g., computer related fraud, unauthorized Internet browsing)

The Sarbanes-Oxley Act
The repeated revelations of fraud and abuse precipitated a public demand for changes. In response, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), the intent of which was to raise the standards of corporate accountability, improve the detection and prevention of fraud and abuse, and reassure investors and other users of financial information that they have a level playing field. Key provisions of SOX include the following:

- It created the Public Companies Accounting Oversight Board (PCAOB), which is charged with establishing auditing, independence, and ethical standards for auditors; conducting investigations of accounting firms; and enforcing compliance.
- It requires the CEO and CFO of a company to certify that financial statements and disclosures are correct.
- It prohibits outside auditors from providing certain non-audit services that would impair the independence of the auditor.
- It requires each annual report to contain an “internal control report” that contains an assessment of the internal control structure and procedures for financial reporting.
- It requires the disclosure of whether the audit committee has at least one member who is a “financial expert.”
- It prohibits personal loans to executives.
- It dramatically increases the penalties for fraud.

What Is Fraud
So what exactly is fraud? PriceWaterhouse-Coopers has defined fraud as a “broad concept that refers generally to any intentional act committed to secure an unfair or unlawful gain.” Michael Comer divided fraud into the following types:

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One way to visualize fraud and to plan its deterrence or detection is to think of it as a pyramid with the base defined by motivation, leading to opportunity, which leads to rationalization to justify fraud or abuse (the so-called fraud pyramid). The factors within the fraud pyramid are as follows:

**Motive**
- Excessive spending to keep up appearances of wealth
- Other outside business financial strains
- An illicit romantic relationship
- Alcohol, drug, or gambling abuse problems

**Opportunity**
- Lack of internal controls
- Perception of detection = proactive preventative measure

**Rationalization or Lack of Integrity**
- “Borrowing” money temporarily
- Justifying the theft out of a sense of being underpaid (“I was only taking what was mine”)
- Depersonalizing the victim of the theft (“I wasn’t stealing from my boss; I was stealing from the company”)

The amount of fraud that is committed annually is staggering. The 2004 Report to the Nation on Occupational Fraud and Abuse estimates that organizations lose 6% of annual revenue to fraud and abuse. The report also states that fraud and abuse cost U.S. organizations more than $660 billion annually ($4,500 per employee). When it comes to stopping fraud, it is in the opportunity area of the fraud triangle that a company can have the greatest impact.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) analyzed instances of fraudulent financial reporting alleged by the SEC in Accounting and Auditing Enforcement Releases issued during the 11-year period between January 1987 and December 1997. These releases contain summaries of enforcement actions by the SEC against public companies and represent one of the most comprehensive sources of alleged cases of financial-statement fraud. The search identified almost 300 companies, and a random selection of 200 served as the final sample that was examined in detail. The major findings include the following:

- Top senior executives were involved in 83% of the cases. In 72% of the cases the chief executive officer (CEO) was involved, and in 43% of the cases the chief financial officer (CFO) was associated in financial-statement fraud.
- The audit committees of the companies engaged in financial-statement fraud generally met only once a year.
- Insiders or outsiders with special ties to the company or management dominated the board of directors of the identified companies. They typically comprised about 60% of the board and collectively owned nearly one-third of the company’s stock.
- Family relationships among the directors and/or officers affected nearly 40% of the companies.
- The amounts of the fraud were relatively large compared to the size of the companies. The average financial statement misstatement or misappropriation of assets was $25 million, with the average company having assets of $533 million.
- Most frauds overlapped at least two periods, frequently involving both quarterly and annual financial statements.
- The typical financial-statement fraud involved the overstatement of revenues and assets. Over half the fraud involved revenue recognition issues by recording revenues prematurely or deliberately misstating revenues. About half the fraud also involved the overstatement of assets by underestimating the allowance for receivables; overstating the value of inventory, property, plants, equipment, and other...
fixed assets; and recording nonexistent assets.

- Over half the audit reports (55%) issued in the last year of the fraud period contained unqualified opinions.

Accounting Profession's Inaction

Unfortunately, the accounting profession has been reluctant to assume responsibility for the detection of fraud, and only in recent years have auditing rules specifically addressed the need to uncover fraud. In 1998, at the request of the chairman of the SEC, the Public Oversight Board appointed a panel called the Panel on Audit Effectiveness that consisted of eight members who were charged with thoroughly examining the current audit model. In 2000, the Panel issued a 200-page report, Reports and Recommendations, which included a recommendation that auditors should perform forensic-type procedures during every audit to enhance the prospects of detecting material financial-statement fraud.

The Panel on Audit Effectiveness recommended that the following surprise or unpredictable elements be incorporated into audit tests:
- Recounts of inventory and unannounced visits to locations
- Interviews of financial and nonfinancial client personnel in different locations
- Requests for written confirmations from client employees regarding matters about which they have made representations to the auditors
- Tests of accounts not normally performed annually
- Tests of accounts traditionally or frequently deemed “low risk”

In response, the accounting profession issued Statement on Auditing Standards (SAS) No. 99 which did expand guidance for detecting material fraud. SAS No. 99 recommended the following:
- Brainstorming (requires the audit team to discuss the potential for a material misstatement in the financial statements due to fraud)
- Increased emphasis on professional skepticism
- Discussions with management
- Unpredictable audit tests
- Responding to management override of controls
- Unannounced recounts of inventory
- Testing high-risk accounts

Although SAS No. 99 does not require the use of forensic specialists, it does state on page 23 that “an auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology (IT) specialists, or by assigning more experienced personnel to the engagement.”

It is important to understand how the role of a forensic accountant differs from an auditor. An auditor determines compliance with auditing standards and considers the possibility of fraud. A forensic accountant has a single-minded focus on the detection and deterrence of fraud.

Materiality Is Unimportant

In auditing, materiality is an important governing standard in terms of transactions that require investigation. Materiality is often defined in terms of a transaction's or account's relative size as compared
to revenue or total assets. In a forensic investigation, materiality means something entirely different. As pointed out by Lorraine Horton, “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.” For example, checking the payment made to a utility company may lead to the discovery of an executive’s $4 million condo on the books of a corporation. Under the cockroach theory of fraud, there is never just one incident or red flag of fraud.

To illustrate the importance of small details, consider the following example. A former Scotland Yard scientist tried to create the world’s biggest fraud by authenticating $2.5 trillion worth of fake U.S. Treasury bonds. When two men tried to pass off $25 million worth of these bonds in Toronto in 2001, a policeman noticed the bonds bore the word “dollar” rather than “dollars.” Police later raided a London bank vault and discovered that the bonds had been printed with an ink jet printer that had not yet been invented. For example, bonds had been printed with an ink jet printer that had not yet been invented. The police later raided a London bank vault and discovered that the bonds had been printed with an ink jet printer that had not yet been invented.

In addition, zip codes were used even though they were not introduced until 1963.

**Walkthroughs Are Recommended**

The PCAOB recommends that an auditor perform at least one walkthrough for each major class of transactions. A major class of transactions is identified as similar transactions that are significant to the company’s financial statements. A walkthrough requires an auditor to trace a transaction from origination through the company’s information systems until it is reflected in the company’s financial reports. The walkthrough should include the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified. Walkthroughs are vital in evaluating the effectiveness of an internal control system.

The standard set by the PCAOB sets a minimum for auditors. However, for forensic specialists one walkthrough is barely sufficient. Why are walkthroughs so important? Consider the following example. On October 14, 2002, a New York Times article by Joel Brinkley stated, “Auditors studying the financial records of federal government departments find many of them so disorganized, even chaotic, that the agencies cannot account for tens of billions of dollars.” So how did the agencies make their books balance? Some agencies apparently believe in the magic of top-side balancing entries.

The Forest Service, an agency of the U.S. Department of Agriculture, tried to balance its books at the end of the 2001 fiscal year. It booked more than 15,337 adjusting entries, debits, and credits totaling more than $11 billion gross. Auditors determined that 73% of these adjustments, totaling $7.9 billion, were unsupported.

In a similar fashion, a forensic accountant or auditor should wander around the entity being audited to informally observe the setting: the employees while entering and leaving and while on lunch break; posted material, instructions, and job postings; information security and confidentiality; and compliance with procedures. These observations are especially valuable when assessing the internal controls.

**Forensic Investigations**

A forensic investigation can be reactive or proactive. A reactive investigation occurs when there is some reason to suspect fraud or a significant loss gives good reason to consider the possibility of fraud. A proactive approach is preventative and involves a review of internal controls and the identity of those areas most subject to fraud.

Fraud detection can involve the following types of engagements:

- Determining if fraud is occurring
- Supporting criminal or civil action against dishonest individuals
- Forming a basis for terminating a dishonest employee
- Supporting an insurance claim
- Supporting the defense of an accused employee
- Determining whether assets or income were hidden by a party to a legal proceeding (such as a bankruptcy or divorce)

- Identifying internal controls to prevent fraud from happening again

The forensic specialist has different techniques that can enable him or her to gather evidence to determine the incidence of fraud. Among the techniques commonly used by forensic experts are the following:

- Public document reviews and background investigations (nonfinancial documents)
- Interviews of knowledgeable persons
- Confidential sources
- Laboratory analyses of physical and electronic evidence
- Physical and electronic surveillance
- Undercover operations
- Analyses of financial transactions

Forensic accountants must be aware that the data-driven approaches do not detect all fraud schemes such as bribery and kickbacks. Often corruption and collusion involve the circumvention of control by top executives. So searching the relevant transactions data for patterns, red flags, and unexplained relationships may not yield positive results because the information may not be recorded within the system. Thus, “behavioral concepts and qualitative factors frequently allow the auditor to look beyond the data, both with respect to data that is there and data that isn’t.”

Like Sisyphus, the mythological character who was condemned to roll a rock up a hill each day only to watch it roll back down again, external and internal accountants cannot seem to make much progress in eliminating fraud from financial statements and the workplace. “During one investigation, we found in the auditing working papers a statement written in the margin of the internal audit working paper by the internal audit manager: ‘Conceal from bankers’” says Nichols L. Feakins, CPA, partner at San Mateo, California, based forensic accounting firm Feakins & Feakins. “It sounds amazing, but the [third party] auditors had put B-level staff on the project who simply didn’t read the documents and missed it.”

42 THE FORENSIC EXAMINER Fall 2005
Conclusion
Fraud has become an issue of major importance in the public arena since the shocking revelation of the financial difficulties of Enron and a succession of other companies such as WorldCom. The ensuing public outcry resulted in the passage of the Sarbanes-Oxley Act of 2002, the most far-reaching legislation affecting the securities markets since the SEC acts of 1933 and 1934. The passage of SOX required the formation of the PCAOB, whose charge is the passage of rules intended to strengthen auditor independence and improve financial transparency. However, the need for forensic specialists has not declined even with the effort to pass laws and regulations intended to deter the incidence of fraud.

Two new polls reported by Fortune Magazine show the continuing pressure on executives to meet earnings targets and the temptation to utilize accounting tricks to achieve those targets. A survey by CFO Magazine found that since 2001, 18% of financial executives said that they felt more pressure to use tricky accounting methods to make results appear more favorable, while 51% felt that there was no change in pressure to manipulate accounting numbers as compared to 2001.

Another study from Duke University revealed that while only 8% of CFOs would be willing to use accounting tricks, 80% would decrease discretionary spending and 55% would delay new projects to meet the earnings target.11 These results confirm the continuing pressure on financial executives to produce artificially higher profits and the need for continued vigilance to prevent fraud and abuse.

Fraud accounting specialists such as Certified Forensic Accountants, Cr.FAs, who are trained to aggressively detect the potential for fraud are going to be in continuing demand to supplement the efforts of auditors.

References

About the Authors
Nicholas G. Apostolou, DBA, CPA, is a Certified Forensic Accountant (Cr.FA) and a Diplomate of the American Board of Forensic Accounting. He works as a U. J. LeGrange Professor at Louisiana State University.

D. Larry Crumbley, PhD, CPA, is a Certified Forensic Accountant (Cr.FA) and a Diplomate of the American Board of Forensic Accounting. He is a KPMG Endowed Professor at Louisiana State University.

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