Forensic Accounting

An Honors Thesis  (HONRS 499)

by

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PURPOSE OF THESIS

This discussion of forensic accounting begins with a definition of fraud and the distinct types of fraud that are encountered in today’s society. Along with this background information on fraud, this thesis also includes the different reasons that an individual commits fraud. The role of the auditor in the detection of fraud is also reviewed, along with the public’s perception of the auditor’s responsibility compared to the auditor’s performance. Finally, there is a discussion about the skills and services that a forensic accountant provides, along with the requirements for becoming a certified fraud examiner.
Imagine, Barry Minkow, an average sixteen year old Los Angeles teenager from a working class neighborhood starting a multi-million dollar business (ZZZZ Best). This business began as a carpet cleaning service in Barry’s parent’s garage and turned into a business that restored fire and flood damaged buildings. By the time Barry was twenty-one, the market value of ZZZZ Best was over $200 million (Matzer 1994). Barry may seem like a youth genius, and rightfully speaking he probably was, except for the fact that the entire business was a complete scam.

In the beginning, Minkow played fair, but he grew frustrated because bankers would not let a young unproven businessman borrow money. Barry then turned to loan sharks for the needed money. He also started billing credit card customers for jobs never completed to repay the loans (Kelly 1990). One may ask how could this happen with all of the rules and regulations set forth by the business profession. By possessing a little creativity along with finesse, maturity, and innocence, Barry Minkow was able to entice investors and lenders to obtain over one hundred million dollars. He also had the unwitting complicity of many lawyers, accountants, and investment professionals, who were also Barry’s victims.

The entire ZZZZ Best business was on paper only, there were no sales only fabricated projects, some reportedly worth over seven million dollars. Until then no carpet restoration job in U.S. history had ever exceeded $2.5 million (Kelly 1990). In 1986, Larry Gray, partner-in-charge of auditing at Ernst & Whinney (now Ernst & Young) demanded to see the project to restore a damaged building in Sacramento worth seven million dollars. Barry stalled Gray by lying and saying his contracts restricted access to the building for liability reasons. The lies only bought
Barry some time because the auditors were threatening to hold up the planned *ZZZZ* Best stock offering and were not going to endorse *ZZZZ* Best's "fake" financial statements.

Of course there was no Sacramento job so one had to be fabricated. Barry sent two of his accomplices to Sacramento to find one. There was only one building that could possibly have that much damage. They told the building managers they needed to lease a large amount of space but that the investors could only come on a weekend to inspect it. Barry told Gray that he could only inspect the building on a weekend so as to not interfere with any ongoing work, but actually to prevent him from talking with anyone that could destroy their plan. To make sure that Gray would not contact the building owners to verify the project, Barry set up an instant office called Assured Property Management (that also only existed on paper). Assured Property Management’s sole purpose was to look after the interests of the insured party in numerous restoration projects. Barry’s men did not overlook any small detail, such as memorizing the way from the airport to Assured Property Management and the restoration building and making it seem as if they had driven it many times before. They even tipped the security guard so he would be extra nice to their guests and act as if he knew Barry well. In the building they posted *ZZZZ* Best signs all over and even left a *ZZZZ* Best T-shirt in an empty room. Barry also carried a set of blueprints around with him so that he would look official (Akst 1989).

The tour went beautifully, at least for Barry. Gray had walked through a building that had not been damaged and repaired at all and was completely fooled. This success made it possible for Barry to continue to raise astronomical amounts of money all for a "fake" business. Bankers were now coming to him to offer loans. Right before Barry knew he would be giving the bank a huge deposit from his stock offering, he decided to get as much money as he could from them.
first. He told the bankers that, because of the publicity with the stock offering, ZZZZ Best had been awarded an $8.2 million restoration project in San Diego as well as other major projects, and that he needed more money to invest in these projects. He borrowed $1.3 million with a $7 million line of credit.

Again the accountants became a little skeptical and wanted to see another project, this time the $8.2 million project near San Diego. The first trouble occurred when Barry told the accountants and lawyers that the job was in National City, a small town outside San Diego. When Barry’s men arrived, there was no building even close to having an 8 million dollar restoration job. To overcome this obstacle they leased a warehouse building in which they said the supplies were kept for the project that was actually in San Diego. To fill the warehouse they ordered $168,000 of the cheapest carpet they could find. They were fortunate to find a building to lease due to the collapse of the Savings and Loan Association (Akst 1989).

They worked this setup just like the one in Sacramento. Once again Gray toured a building that ZZZZ Best had done nothing to. The real test for ZZZZ Best came when Gray asked to see the San Diego project after he had been told it was completed. Their first problem came in trying to lease the same building after they declined to lease it after the first visit from Gray. One of Barry’s accomplice’s brother saved the day by flying in and explaining to the building owners that ZZZZ Best was the one that wanted to lease the building but didn’t want it to become public because of the unusual activity in their stock. Barry confirmed his story and so the lease was signed.

Since no one in ZZZZ Best knew anything about restoring a building, they hired a building contractor to whom they gave unlimited access to a bank account. Barry even had the workers
pose for pictures in ZZZZ best T-shirts. The whole project cost Barry one million dollars but he knew that one must “spend money to steal money.” When Gray was given the tour, he did not even notice that some of the closet doors would not even open because the ceiling was dropped so low in front of them (Akst 1989).

In 1987, ZZZZ Best’s final year of business, they reported $50 million in revenues when the true amount was only $9 million. When some of ZZZZ Best’s few real customers complained about their work, Barry had them beaten up. Minkow’s business was based on borrowing money to finance "fake" carpet cleaning jobs, borrowing more money to pay off his debts, and then to skim off cash to live a rich lifestyle. The way Minkow threw around money assured many investors of ZZZZ Best’s profitability (Kelly 1990).

Mark Morze, one of Barry’s accomplices, revealed that ZZZZ Best’s auditors were plain lazy and should have been able to detect the fraud if they had done their job. In one incident when the auditors wanted a sample of 400 invoices from which they would select 20 to verify, Mark faked 20 invoices on his computer and gave them to the auditors. When the auditors said they needed to see the 400 original invoices, Morze protested so they backed down. Other incidents included not driving out to verify an actual address but just making a phone call, accepting badly Xeroxed copies instead of the originals, and never once seeing an original source document (Naff 1994).

Law enforcement officers investigated ZZZZ Best after Daniel Akst wrote an article about Barry’s credit card overcharges from when he first started his business. Barry blamed the credit card fraud on a man who later became ZZZZ Best’s senior vice president. This made the whole business very peculiar to journalists writing stories about the success of the company.
In court, Barry Minkow was sentenced to 25 years in prison for the ZZZZ Best scam, with one year in solitary confinement. While in prison he wrote an autobiography from which any money made would go into a restitution fund for his victims, to whom he owes over $26 million. He was released early from prison for good behavior and his efforts to improve himself. He is now starting a second book on how to avoid being scammed (Matzer 1994). This is one of the most well-known fraud cases in history and hopefully not only the auditors, but also the general public, will be able to learn from it.

INTRODUCTION

In order to understand the entire concept of fraud and forensic accounting, which is the sole purpose of this thesis, the first step is to define the term fraud. Another important aspect is to illustrate the different ways in which fraud is committed and the reasons why it is committed. One must also understand the auditor’s responsibilities in detecting fraud and the guidelines that he or she must follow. The new auditing standard on fraud is also discussed. Along with the external auditor’s responsibilities, this paper also looks at certified fraud examiners and the skills and services that they provide. This thesis on forensic accounting will explain the important requirements for becoming a certified fraud examiner and how this profession has evolved through the years.

DEFINITION OF FRAUD

Fraud is defined as “dishonesty in the form of an intentional deception or a willful misrepresentation of a material fact (Bologna and Lindquist 1995, 10).” Fraud is a generic term, and includes all the diverse ways in which a person can invent to get an advantage over another by false representations. It can be committed against customers, creditors, investors, suppliers,
bankers, insurers, or government authorities. Fraud is found at all levels of an organization and is not limited to top company management (Bologna and Lindquist 1995).

Fraud can be divided into two categories, collusive and non-collusive fraud. Collusive fraud involves two or more people and, if skillfully executed, is almost impossible to detect through normal audit procedures. Collusive frauds are generally committed by an insider and an outsider of the company and are specifically configured to be undetectable by the internal control system. Collusive frauds are usually only detected as a result of carelessness, a disagreement among the participants, or some personal or accidental reason rather than as the result of an audit. Non-collusive fraud, on the other hand, can occur when an employee either accidentally or intentionally finds a hole in the internal control system and uses it to perpetrate the fraud. This type of fraud can only be successful if it is small in proportion to the total transaction and the weakness in the control system continues to prevail (Jacobson 1990).

**TYPES OF FRAUD**

Fraudulent financial reporting and misappropriation of assets are two different types of irregularities or intentional misstatements of amounts or disclosures in the financial statements. Irregularities include fraudulent financial reporting undertaken to make financial statements misleading, sometimes called management fraud. Misappropriation of assets is sometimes called defalcation (Bologna et al. 1993). Management fraud can include a misrepresentation of corporate unit’s performance levels by employees serving in management roles. These same employees may seek to profit from the fraud in terms of promotions, bonuses, or other economic incentives. Misappropriation of assets or defalcations is when employees steal assets for their
own personal benefit. The most common type of defalcation is the theft of cash. Some examples of techniques used include: not recording sales and writing off receivables as uncollectible.

Management fraud and defalcations can also be referred to as fraud for or against the company. Management fraud can be intended to benefit not only the perpetrator but also the entire company: whereas defalcations are intended to benefit only the perpetrator. Frauds for the company are committed mainly by senior managers who wish to strengthen the financial position of the company through such schemes as overstating income. On the other hand, frauds against the company are designed to benefit only the perpetrator through an increase in salary or bonuses (Bologna and Lindquist 1995).

THEORY OF OPPORTUNITY, PRESSURE, AND PERSONALITY

Fraud or intentional deception is a “strategy to achieve a personal or organizational goal or to satisfy a human need (Bologna and Lindquist 1995, 10).” Some of the main reasons for committing fraud include: to obtain money or other assets, to eliminate a liability, to relieve boredom, revenge, or the feeling that everybody else is doing it (Jacobson 1990). Many frauds are committed for non-monetary reasons as some of the examples above illustrate.

Evidence indicates that fraud can result from interactions between an individual's personality and the external environment. These interactions can be grouped into three major categories of variables: "situational pressures, opportunities to commit fraud, and personal characteristics (Albrecht et al. 1980, 64)." The right combination of these factors can persuade one to ultimately commit fraud.

To illustrate this interaction, visualize a balance scale with three connecting bars at the top representing the three categories of interaction. Each bar has a weight that can be moved
independently and in either direction. The combination of the bars and the position and volume of the three weights indicates the degree or likelihood of an individual committing a fraudulent act based on his or her opportunity, pressure, and personality (Albrecht et al. 1980).

The interaction of these three major forces can influence the decision to commit fraud or not to commit fraud. A person with a high level of personal integrity and no opportunity or pressure to commit fraud will nearly always behave honestly. On the other hand, fraud becomes increasingly probable as individuals with less personal honesty are placed in positions with increasing pressure and greater opportunities. All variables in the balance scale contributing to fraud accumulate until the weight is adequate to result in a fraudulent act. For example, a fraud could result under any circumstance if a person is motivated enough, even in the absence of external opportunities or pressures. A more likely situation would involve a situational burden at the personal level, such as a debt, being combined with a tendency to be dishonest in order for the fraud to take place. Pressures from others who have cheated or a lack of accounting controls would also increase the likelihood for fraud (Albrecht et al. 1980).

The scale tends to be pulled in one direction more than the other because fraud is continually increasing in today's society. This is due to the fact that society has reduced the costs or consequences of being caught and at the same time enlarged the benefits associated with fraud. For example, businesses do not prosecute offenders because of bad publicity, whistleblowers are ostracized, and societies lack of ethical training (Albrecht et al. 1980).

Fraud perpetrators come from all walks of life, economic backgrounds, and social groups. The story of a CPA named McKinley illustrates how the most unlikely thief rationalizes his behavior. McKinley obtained a job as chief financial officer of a well known bank where he stole
$100,000. He was in a financial jam and decided to "loan" himself out of it. He moved the money he needed to a checking account he controlled and charged it to the bank's expense. The combination of the three factors: opportunity, pressure, and personality made McKinley decide to commit fraud (Wells 1990).

MECHANICS OF FRAUD

Two basic theories comprise the mechanics of fraud: the theory of concealment and the theory of deviations. The theory of concealment consists of on-book or off-book frauds. An on-book fraud is one that occurs within the business. Fraudulent activities are recorded, usually in some concealed manner, in the regular books and records of the company. Even though it may seem totally hidden, an audit trail normally exists, although it may be hard to recognize (Thornhill 1995). An off-book fraud normally occurs outside the accounting system and leaves no audit trail. To occur, the company usually has unrecorded vendor rebates or significant cash sales. Examples of off-book fraud include bribery and kickbacks.

An upward lifestyle change, such as the purchase of a new home and car while taking expensive vacation without a change in salary, by a particular officer or employee may be an indication of something irregular going on. When no logical explanation for the increase in wealth can be obtained, a fraud investigation may be conducted. The extra effort to detect off-book frauds can be justified because they usually involve larger dollar amounts than on-book frauds.

The theory of deviations is when fraud is considered an abnormal behavior because it is contradictory to the desired rules of sociology. Fraud perpetrators seek out ways to conceal their guilt and hide their wrongdoing because they do not want to be discovered. Deviations from the accepted procedures are often the first indication of this type of fraud (Thornhill 1995).
AUDITOR’S ROLE IN THE DETECTION OF FRAUD

The increase in management fraud over the last decade has aroused concern in the business community. The number of companies being defrauded and the dollar amounts of fraud have increased along with an increase in occurrence. For these reasons the courts, the financial press, regulatory bodies, and concerned investors all have been urging for the past several years for more effective audits in the detection of fraud.

The accounting profession responded to this concern and began to acknowledge a greater responsibility for the detection of fraud. Statements on Auditing Standards (SAS) No. 16, *Independent Auditor’s Responsibility for the Detection of Errors or Irregularities*, and No. 17, *Illegal Acts by Clients*, are just two of the steps the accounting profession has taken towards redefining the role of the auditor in fraud detection. It is important for auditors to understand the nature of fraud, the environments from which it arises, its likely causes, the controls that deter fraudulent activity, and the techniques that can be used to detect fraud once it has occurred (Albrecht et al. 1980).

COHEN COMMISSION

In addition to the SASs, the American Institute of Certified Public Accountants assembled the Commission on Auditor’s Responsibilities (the Cohen Commission), which developed conclusions and suggestions concerning the appropriate responsibilities of independent auditors. The Commission concluded that “an auditor has a duty to search for fraud, and should be expected to detect those frauds that the exercise of professional skill and care would normally uncover (Albrecht et al. 1980, 63).”
SAS NO. 1

In the early nineteen hundreds, the profession moved the focus of an audit away from fraud detection toward a broader responsibility of determining “fair” presentation. According to SAS No. 1, the ordinary opinion audit was not intended, primarily or specifically, to disclose defalcations or irregularities and should not be relied on to do so. Auditors were only responsible if they did not detect defalcations and irregularities because of their noncompliance with Generally Accepted Auditing Standards (GAAS). Auditing then moved into an era where its only concern was if the fraud would “materially” affect the financial statements. The reliance for the prevention and detection of fraud was placed on the internal control system.

Accountants are now being told that they must play a much greater role in detecting fraud through their audits. Despite auditors’ repeated assertions that uncovering fraud is not their primary role, Congress, regulators, the courts, and even the accounting profession are pressuring auditors to probe more deeply. The role of the auditor started to be redefined at a two-day session, arranged by Peat, Marwick, Mitchell & Co. in 1978. This is where several dozen representatives from other professional disciplines such as sociology, psychology, and criminology met. The insights from these areas helped form new approaches and responsibilities of auditors. The auditor may use these insights to understand how administrators think and operate, thus expanding his or her awareness of where management fraud might occur. An example of one psychological insight is that an executive who is a “super competitor” might be more inclined to go astray. Another psychological insight is a manager who is an “idealist” may be less fraud-prone than a fellow executive who is a “cynic.” All of these reasons make an auditor more alert to these types of conditions and activities where irregularities may occur.
SAS NO. 16

According to SAS No. 16, an auditor's responsibility is to plan, within the limitations of the audit process, an examination to search for errors or irregularities that would have a material effect on the financial statements. The standard audit report implies that the auditor believes the statements are not materially misstated because of errors or irregularities. The scope of the examination for errors/irregularities is affected by: consideration of the internal control system, results of substantive tests, and circumstances that raise questions concerning the integrity of management.

SAS NO. 17

SAS No. 17, *Illegal Acts by Clients*, was issued in response to corporate disclosures of illegal or questionable practices and the responsibility of the auditor in these situations. It sets forth guidelines for conduct in fulfilling an obligation to report on statements in accordance with professional standards, after becoming aware of an illegal act. However, Standard No. 17 is not without its limitations. One such limitation is that an audit examination cannot be expected to provide assurance that a illegal act will be detected. Another limitation lies in the fact that the further removed an illegal act is from the events and transactions reflected in financial statements, the less likely the auditor is to recognizing its illegality.

Users of financial statements expect auditors to bring to the reporting process technical competence, integrity, independence, and objectivity. They also expect auditors to search for and detect material misstatements, whether intentional or unintentional, and to prevent the issuance of misleading financial statements. The accounting profession must first recognize its responsibility
to design the audit scope to consider the potential for fraudulent financial reporting and to design audit procedures to detect such reporting.

INHERENT LIMITATIONS OF AN AUDIT

The first step should be a restatement of the auditor's responsibility for detecting fraudulent financial reporting. Users, who rely upon the auditor's work and opinion, should clearly understand the nature, the scope, and the limitations of an audit. Audits have limitations that should be communicated to the users of financial statements. The inherent limitations of an audit are:

1. Examination is based on the concept of selective sampling, thus an inherent risk of material errors/irregularities not being detected exists.

2. Reliance on the truthfulness of representations and on the genuineness of records and documents is reasonable, unless evidence suggests otherwise.

3. Auditors cannot be expected to extend auditing procedures to seek unrecorded transactions, unless evidence indicates their existence.

TREADWAY COMMISSION

In response to rising anxiety about the adequacy of financial reporting practices, in 1985 the National Commission on Fraudulent Financial Reporting, commonly called the Treadway Commission was assembled. Their purpose was to identify the causes of fraudulent financial reporting and to suggest steps to decrease the occurrence of such reporting. The Treadway Commission issued its report in October 1987. The report contained 49 recommendations to deter fraudulent financial reporting.
The Treadway Commission placed primary responsibility for fraud prevention on management, indicating that the overall tone set by management influences the corporate environment within which financial reporting occurs. Most importantly, the Treadway Commission recommended many changes to the method in which auditors manage their audits of publicly owned institutions. Foremost among the recommendations was one that stated that GAAS should be changed to better distinguish the independent public accountant's responsibility for detecting fraudulent financial reporting. The Treadway Commission confirmed that the auditor has a responsibility to design the audit to detect material fraud and that the auditing standards should distinctly describe the auditor’s responsibility.

EXPECTATIONS GAP

An “expectations gap” is the difference between the performance of auditors and the expectations of the users of the financial statements. An example of this would be when an independent auditor gives an unqualified opinion on a company’s books when the company is on the eve of financial collapse. The annual review of a company’s financial statements by outside accountants is an important defense for investors against financial shenanigans. Factors that may contribute to an expectations gap include:

1. Public’s misunderstanding of the role and function of an audit (as shown above).
2. Trend of court cases in the 1960s and 1970s.
3. Historical roots of auditing and its original purpose.

SAS NO. 53

In April 1988, the AICPA’s Auditing Standards Board adopted new “statements on auditing standards” to reduce the “expectations gap” between what the public and financial
statement users believe auditors are responsible for and what the auditors themselves believe their responsibilities encompass. Under SAS No. 53 auditors have a responsibility to plan audits to provide the “reasonable assurance of detecting errors and irregularities that are material to the financial statements” of issuers. Auditors who discover management fraud during an audit are ordinarily obligated to bring it to the attention of senior management and the board of directors or the company’s audit committee. If there is a lack of integrity at the top level of management, the auditor is expected to resign without completing the audit. “The Dingell Amendment” calls for the auditor to notify the Securities and Exchange Commission of material illegal acts in circumstances in which management and the board of directors fail to take appropriate corrective (Deloitte & Touche Review 1990).

NEW SAS ON FRAUD

In May 1996, the American Institute of CPAs auditing standards board issued the Statement on Auditing Standards, Consideration of Fraud in a Financial Statement Audit. The standard’s purpose is to help auditors detect material misstatements caused by fraud and to reaffirm the auditor’s responsibility with regard to material misstatements. It also is designed to help close the expectations gap relating to a CPA’s responsibility to detect fraud. In addition, the standard provides additional guidance on the standard of due professional care in work performance, encompassing the need to exercise professional skepticism, and the concept of reasonable assurance. Although the auditor’s responsibility to detect material misstatement due to fraud is not changed with the new statement, the ASB determined that a performance standard was necessary in order to assist the auditor in carrying out that responsibility.
This new Statement on Auditing Standards (SAS), "Consideration of Fraud in a Financial Statement Audit:"

1. Describes fraud and its characteristics.

2. Requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors that should be considered in the auditor's assessment.

3. Provides guidance on how the auditor should respond to the results of the assessment.

4. Provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.

5. Describes related documentation requirements.

6. Provides guidance regarding the auditor’s communication about fraud to management, the audit committee, and others (Exposure Draft).

The Auditing Standards Board determined that clarification of an auditor’s responsibility was necessary. In achieving this, the ASB made it clear that the term misstatements includes both error and fraud. An extended discussion of reasonable assurance is encompassed beneath the broad standard of due professional care, along with portrayals of the nature of audit evidence and professional skepticism, and the characteristics of fraud. Because SAS No. 53 is superseded, the guidance on errors in SAS No. 53 is relocated to SAS No. 47, Audit Risk and Materiality in Conducting an Audit. The ASB also concluded that since either kind of fraud can result in a material misstatement in financial statements, both types are noted in the new standard. This new standard also suggests that auditors document how fraud risk factors and other conditions were
examined in the audit process, and the fraud risk factors that the auditor believes impact the risk of material misstatement.

**SKILLS OF A FORENSIC ACCOUNTANT**

When the external auditor is not qualified to perform the specialized fraud detection skills, one needs an “expert” forensic accountant to complete the audit. According to Thornhill (1995) forensic accounting is “the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence.” It comprises financial expertise, fraud knowledge, and a strong understanding of business and the working of the legal system. Forensic accounting has been developed through on-the-job training along with experience with investigating officers and legal counsel (Thornhill 1995). Accountants focusing their professional experience on proceedings requesting them to testify in court as to the conclusions of an investigation of accounting and financial evidence are labeled forensic accounting experts. The forensic accounting expert must maintain a range of skills to professionally carry out financial investigations. These skills include not only expert accounting and business knowledge, but the legal process as well (Bologna et al. 1993).

**ACCOUNTING AND AUDITING KNOWLEDGE**

An extensive knowledge of the regulations, practices, and standards of the accounting profession is a necessary part of being a forensic accountant. Auditing skills are also an important foundation for a forensic accountant. By having both accounting and auditing knowledge, one also possesses a practical understanding of business in general (Thornhill 1995).
FRAUD KNOWLEDGE

Fraud knowledge is an important aspect of the forensic accountant's skills. He or she must have exposure to and knowledge of many different types of fraudulent transactions in order to recognize "red flags" and to piece together patterns and theories that may otherwise escape the accountant who has not had the same degree of exposure to fraud. A forensic accountant must be able to identify accounting problem areas, rank these problem areas or topics as necessary, and properly clarify the focal point of the investigation or refocus the investigation as new information is acquired and evaluated. The importance of experience can be demonstrated when the forensic accountant, having knowledge of many different types of fraud based on first-hand investigative experience, obtains a more effective plan of investigation. The more fraud-based cases the forensic accountant has been involved in, the broader his knowledge base (Bologna et al. 1993).

KNOWLEDGE OF LAW AND RULES OF EVIDENCE

It is also important for a forensic accountant to have knowledge in both civil and criminal law, since these laws have a direct impact on matters involving him or her. The accountant also needs to comprehend the rules of evidence to guarantee that all findings are allowable in court. Understanding the rules of evidence including: "what evidence is, how it is obtained, how it is preserved, how it is presented before the courts, and how the forensic accountants' own work can become part of the evidence brought before the courts responsible for determining what has occurred (Bologna et al. 1993, 236)" is important for forensic accountants. Along with the rules of evidence, the forensic accountant must also have a general understanding of the events by which a court of law determines an act to be fraudulent.
INVESTIGATIVE MENTALITY

The forensic accountant must have an "investigative mentality" which includes an investigative approach, the persistence of a detective, and the ability to distinguish indicators of fraud. "This mentality encourages the forensic accountant to seek substance over form (Bologna et al. 1993, 236)" and to classify and scrutinize data. It also enables him or her to conduct interviews in order to ascertain what has actually resulted in a business transaction, rather than what merely appears to have happened. A question that is sometimes asked is whether a certain action seems rational and reasonable. Investigative mentality is also thought of as "professional, critical skepticism (Bologna et al. 1993, 237)." This is a distinct and definite set of judgmental procedures that permits the forensic accountant to analyze and value all applicable facts and form hypotheses. The forensic accountant never "discounts" any aspect of an investigation on face value. It is after inspecting all obtainable evidence and considering its entirety that he or she will judge an item to be relevant to the issues at hand.

A typical external auditor does not search for fraud in the process of an audit, but will react if warning signs or red flags emerge through audit procedures. The forensic accountant, on the other hand, diligently pursues the presence of evidence, all of which when examined simultaneously may suggest the occurrence of a fraudulent act. This disciplined approach of the forensic accountant is intended to maximize fraud detection. The principal objective is to identify whether or not fraud exists and, if so, who is involved. The success rate for a forensic accountant in detecting fraud is significantly greater than that of a regular auditor (Thornhill 1995).
UNDERSTANDING OF PSYCHOLOGY AND MOTIVATION

The forensic accountant must also have a broad knowledge of why people act as they do regarding wrongdoing and the attributes of an individual who commits fraud. He or she must be able to understand the “human element (Bologna et al. 1993).” Documents and computers do not perpetrate fraud, but rather people commit fraud. It can be said that people respond to satisfy needs. The forensic accountant must identify the presence of such needs during his or her investigation, whether it is the need of an employee for larger income to sustain an extravagant lifestyle or the need of a sales manager to maintain sales volumes in a declining market so as to secure his or her employment. These needs provide the motivation for acts, which are called fraud. In a situation where an individual has both the need and the opportunity to commit fraud, a fraudulent act may be the outcome (Bologna et al. 1993).

COMMUNICATION SKILLS

Forensic accountants, as expert witnesses in the court of law, must be able to both display and justify their findings and conclusions. He or she must be able to clearly and effectively communicate his or her information. As the forensic accountant testifies as an expert witness in the court of law, he or she must be able to explain the procedures, accounting charts, analyses, and findings in a way that the reason for his or her expert testimony is understood. This is the case for both their facts and if necessary opinions of the forensic accountant. The forensic accountant must also have the knowledge of the usable evidence and potential alternate explanations of the circumstances to ensure their facts and testimony given are not discredited through cross-examination (Thornhill 1995).
COMPUTERS AND INFORMATION TECHNOLOGY

Forensic accountants must have a complete foundation in computers and all other information technology. They must have the ability to realize the opportunities computers render to possible perpetrators of fraud as well as an ability to use computers in analysis and documentation of an alleged fraud (Bologna et al. 1993).

ETHICS

Ethics also plays an important part in the professional training of accountants. Independence and objectivity are essential aspects in the investigative work of forensic accountants. Information must also be collected in an ethical and legal manner, which is why a forensic accountant must know the legal theories in the court of law. The forensic accountant cannot misrepresent himself or herself when gathering information. He or she cannot abuse the rights of individuals when gathering information. The ethics of the forensic accountant must never be compromised. Any negative fact would have a negative impact on the work the forensic accountant has done on any circumstance before a court.

Forensic accountants must maintain a broad range of skills well above those of a regular accountant in the ordinary setting. They must be able to see the entire picture of the assignment on which they are working. Forensic accountants should also be willing to use others, with different expertise, to add to their efforts. They must also know how to document conclusions and communicate facts and findings, both verbally and in writing.

SERVICES PROVIDED BY A FORENSIC ACCOUNTANT

There are a variety of services that can be provided by forensic accountants. The forensic accountant can assist management by performing reviews applicable to a possible or actual fraud.
This can be accomplished with the forensic accountant either working alone or with other qualified personnel in both accounting and nonaccounting related fraud matters. When various disciplines are combined in a particular fraud review, the forensic accountant often will direct a team of investigators. The reason for the forensic accountant heading up the team is that accounting is the principal managerial information function within an organization and intertwines with every other function. This intertwining experience allows the forensic accountant to communicate with all team members in the investigation process. The evidence that is acquired from the investigation should be in form and substance permissible for use by an attorney in case a criminal or civil court action results from the fraud review findings. The forensic accountant should have an understanding of the federal evidence and related state guidelines.

**MANAGEMENT SUPPORT**

The forensic accountant can provide review expertise to all branches of the legal profession. In a criminal or civil legal action, he or she can work for the prosecution, defense, and even the court. When working for the prosecution, the efforts of the forensic accountant will ordinarily be to corroborate fraudulent activities applicable to accounting transactions or records. To acquire this information, the scope of these reviews will often expand into matters of organization, administration, operations, policies, systems, laws and regulations, and the adequacy or inadequacy of internal controls. The work of the forensic accountant has been used in a variety of circumstances.

Forensic accounting services can also be utilized on behalf of the defense. In most situations, the purpose will be for the forensic accountant to refute or counterbalance a scenario presented or expected to be presented by the prosecution. The defense may have the forensic
accountant develop a contrasting scenario to that of the prosecution, to raise "reasonable doubt" in the eyes of the court. These scenarios are always based on facts developed during a appropriate forensic accounting audit.

LITIGATION SERVICES

A CPA rendering litigation services provides professional support to lawyers in the litigation process. These services may involve damage computations, financial analysis, and expert testimony. CPAs must not only have skills unique to litigation services but also be able to testify believably, and the lawyers who hire CPAs must be content with the CPA’s abilities.

A general knowledge of the rules of evidence and of the civil procedure may be helpful. For example, knowledge of the discovery process will help the CPA understand the options available in acquiring relevant information. If the CPA is to be effective as an expert witness, he or she should have good communication skills and be able to think logically while under pressure. Although CPAs are trained to exhibit financial data in financial statements, the average juror may not understand this type of presentation. Complex information should be turned into an easy-to-understand format; in many instances, uncomplicated graphics can convey the desired point (Cohen et al. 1996).

Close collaboration between the accountant and attorney is important to the development and planning of the case for trial. The accountant will help the attorney in the "weighing and evaluation evidence, formulation questions and evaluating how each piece of information fits in to the bigger puzzle (Bartosiewicz 1995)." Early involvement of the accountant also permits him to become well-acquainted with both the background of the case and the documents obtainable to assist in preparing questions. An added advantage is that the accountant will have the chance,
after a analysis of the data first produced, to concentrate on more distinct and specific areas. At the trial, the accountant and the attorney will have formed a theory on the accounting issues exhibited in the case. Along with presenting the case so that the average juror will understand, the accountant and the attorney should also work together to compose questions for each of the witnesses on the accounting issues. The accountant should also be able to help in designing cross-examination questions for the opposing parties and their CPA. It is also important to have the accountant present during the opposing party’s presentation of issues to assist in discovering errors and inaccuracies with earlier testimony. Teamwork between the accountant and the attorney will guarantee that the client’s concerns will by completely and successfully represented.

**EXPERT WITNESS**

Forensic accountants have also been involved in the legal process as expert witnesses. An accountant working as an expert witness should be instructed about how the legal system regards evidence, expert testimony, and negligence and should always follow their professional responsibilities and moral standards.

The rules of evidence allow the broad usage of expert testimony. Under Federal Rule of Evidence 702, an expert is entitled to testify when specialized knowledge will help the “trier” of fact. Rule 703 permits expert witnesses to form opinions based on three sources of information: first-hand observations, presentations at trial, and preparation of data outside the court. Finally, under Rule 705 an expert is allowed to offer opinions without revealing the underlying data or facts. The expert can be cross-examined by opposing attorneys in regards to the underlying data. The liberal admittance of expert testimony makes the role of an expert witness important to winning a lawsuit (Hanson et al. 1995).
Generally, witnesses are restricted from testifying in the form of opinions, conclusions, and characterizations. They can testify only as to the six senses (see, hear, feel, smell, taste, or touch) and what they know as fact. The one exception to this rule is in the reference to their perception. Qualified experts, such as forensic accountants, may give their professional opinions in any area in which they have relevant expertise. It is fairly routine for forensic accountants to be called upon to testify in criminal and civil prosecutions. Forensic accountants may be an expert for either the prosecution or defense. The extent of such testimony can be comprehensive. They will ordinarily testify relative to reviews in which they were involved. Their testimony can include such matters as accounting, administration, or fraud.

The reliance on forensic accountants is expanding because the practicing professionals have proved their value in a variety of scenarios. In this time of reduced ethics and increased white-collar, management, and corporate fraud, forensic accountants are increasingly necessary. Users of their services understand the importance of reliable facts and evidence being acquired. Because of the expanding awareness of the profession, the forensic accountant will be increasingly called upon to provide management and litigation support and to act as an expert witness. These assignments will include possible or actual fraud, negligence, gross negligence, and mismanagement (Thornhill 1995).

**CERTIFIED FRAUD EXAMINERS**

Part of this immense growth in fraud can be demonstrated by the creation of the National Association of Fraud Examiners (NACFE), which began sponsoring and granting the designation of Certified Fraud Examiner (CFE) as a method to characterize those who possess the specialized skills necessary to investigate fraud. The creation of the NACFE was the first time that fraud
investigation was formally acknowledged as a profession. The NACFE is chartered as a private corporation whose standards for admittance are set by an independent body of its board of regents. The main objectives of the NACFE are to “enhance the professional stature of the CFE designation, to upgrade the study and practice of fraud examination, to provide support for the professional growth and advancement of fraud examiners, and to project a better image and understanding of fraud investigation to others. The NACFE provides training, preparation, examination, and certification in the field of fraud auditing (Rezaee et al. 1993, 46).” The NACFE presently represents more than 7,000 members in business, education, industry, and government in the United States and abroad.

Even the most carefully designed and precisely performed audit will generally not detect instances of fraud where forgery or collusion are involved. The auditor is not skilled in certain areas to the degree where he or she can reasonably be required to reveal these types of frauds. In fact, most audit engagement letters include the caveat that an audit isn’t specifically designed and can’t be relied on, to detect irregularities, or other comparable language. An audit conducted under generally accepted auditing standards is not comparable to a fraud audit.

REQUIREMENTS

If a regular audit is not sufficient to detect fraud, a company must look for someone else to come in and determine if there is fraud when fraud is suspected. The most logical person would be a CFE (Cohenson and Dipasquale 1993). For someone to become a CFE, he or she must successfully meet the following minimum requirements:

1. A baccalaureate degree from a recognized institution;

2. Two years professional experience in a related field; and
3. Successful completion of the CFE examination.

CERTIFIED FRAUD EXAMINERS EXAMINATION

The CFE examination contains four parts: accounting and auditing, criminology and ethics, investigation, and law. The two-day examination is offered in April and October and costs $150. It consists of 500 true/false, multiple choice, and practical problem questions. The minimum passing score of each part is 75%, and candidates must pass all four parts of the exam within three consecutive sittings. Failure to do so will result in forfeiture of the successfully finished sections, and the candidate must retake the entire examination (Rezaee et al. 1993).

Candidates obtain written notification of their scores within 90 days of taking the examination. Between 1988 and 1992, the NACFE has given the CFE examination five times, with a 20% average pass rate on the first attempt. The purpose of the CFE examination is to “establish a reliable, standardized testing instrument that adequately assesses the levels of specialized competence necessary to practice as a CFE (Rezaee and Burton 1992, 15).”

CONTINUING PROFESSIONAL EDUCATION

The CFE candidate’s professional experience must be in a field related to the detection, investigation or deterrence of fraud. Those with extensive auditing or forensic accounting experience will qualify. To retain their expertise, CFEs are required to obtain at least 20 hours of continuing professional education (CPE) annually, or an average of 60 hours over three years. At least half of the CPE must relate directly to the detection and deterrence of fraud (Cohenson and Dipasquale 1993).

The association promotes improved fraud detection and deterrence through a variety of educational seminars and other means, including:
1. Establishing qualifications for the CFE;

2. Preparing and administering the Uniform CFE Examination;

3. Maintaining the competency of CFEs through mandatory continuing professional education;

4. Assisting CFEs in locating suitable employment position; and

5. Assisting parties who wish to retain the services of a CFE.

The CFE program is an accrediting process for individuals who possess the specialized expertise necessary to detect, investigate and deter fraud. Many CFEs have an accounting or auditing background and are employed in numerous fields, including fraud auditing and investigations, forensic accounting, law enforcement, and public accounting.

**FUTURE OF FORENSIC ACCOUNTING**

Forensic accounting is a profession that has, in recent years, attained a broad approval by the legal profession as a significant and beneficial tool. As more and more lawyers become aware of the usefulness of this tool, it can be concluded that the profession will grow. The number of skilled practitioners will have to grow considerably to keep up with the intended expansion in the demands of the profession.

One item is certain and that is that the forensic accounting profession will grow, probably more rapidly in the approaching decade than in the prior decade. Lawyers and management will find a level of comfort and assurance with persons having acknowledged skills and experience in forensic accounting than with other persons without such credentials. "As the profession gains broader recognition, this differential in acceptance and credibility can be expected to increase (Thornhill 1995, 218)."
CONCLUSION

Forensic accounting is a very complex subject. In order to fully understand it one must first be able to define fraud and the many different types of fraud. One must also be able to understand the reasons that fraud is committed, especially the auditors, so that they are able to explain why fraud is being perpetrated. This paper has also gone on to explain the skills and services that a forensic accountant, or certified fraud examiner, must possess and provide. As this thesis displays, the role auditors have played in the detection of fraud has been redefined many times over the past few decades and will continue to change in the future.
BIBLIOGRAPHY


