Chapter 1
Introduction to Forensic and Investigative Accounting

CHAPTER SUMMARY

Overview

This chapter defines a broad approach to forensic accounting and creates a frame of reference for students to read and understand the rest of the book. Upon tracing the threads of forensic accounting through its history and development, students will understand forensic accounting to be a challenging discipline that substantially interacts with economics, finance, information systems and the law.

Definition and Development of Forensic Accounting

1.001 Defining Forensic Accounting

Forensic accounting is the action of identifying, recording, settling, extracting, sorting, reporting, and verifying past financial data or other accounting activities for settling current or prospective legal disputes or using such past financial data for projecting future financial data to settle legal disputes.

Implicitly, there are a couple of other factors to incorporate in the definition: time and purpose. Forensic accounting focuses on the past, although it may do so in order to look forward. Forensic accounting is accounting performed in some circumstances for a specific legal forum; in other circumstances it is accounting performed in anticipation of presentation before a formal forum.

Forensic accountants may be employed in a wide variety of risk management engagements, along with areas such as valuation, damages, intangibles, and so on.

1.011 Historical Roots of Accounting

The history of accounting dates back to temple priests taking inventory of livestock and has evolved through time to such present events as the examination requirements for the CPA certificate being passed by all states.

1.021 History of Financial Reports and Legal Challenges

Financial reports on business operations and performance were created by accountants in the United States, Canada, and Europe for a long time before actual independent audits were mandated. The current system of accounting checks and balances—financial reporting coupled with both internal and external auditing—is relatively recent. Before financials were audited by independent outside experts, the courts were often the place where challenges were made and accounting experts were brought in to give testimony on the disputes in question.

1.031 Threads of Forensic Accounting

Forensic accounting (or at least, accounting expert witnessing) can be traced as far back as 1817 to a Canadian court decision of Meyer v. Sefton. Thus, the website of the Association of Certified Forensic Investigators of Canada maintains that the field of forensic and investigative accounting had its genesis in Canada. Seven years after the Canadian case, on March 12, 1824, a young accountant by the name of James McClelland started his business in Glasgow, Scotland, and issued a circular that advertised the various classes of forensic-type work he was prepared to undertake.
Accounting Literature Parallels Accounting Practice

With the development of accounting literature the role of the accountant as an expert witness was getting growing attention. Articles on the topics of forensics, arbitration, fraud, investigation, and expert witnesses started appearing in the late 19th century. Cleveland Bacon and Alex Moore each contributed articles about expert witnesses.

The Phrase "Forensic Accounting" Is Born

The first person to coin the phrase in print was probably Maurice E. Peloubet in 1946. Kenneth W. Robinson suggested that there is teamwork to be done by lawyers and accountants. In the following year, George B. Pearson, Jr., a former judge, gave 10 warnings to the accountant who wishes to do a good job on the witness stand. Max Lourie, a lawyer employed in the New York Supreme Court published an article in which he suggests that he probably invented the term forensic accounting, although his article appeared seven years after Maurice E. Peloubet had apparently coined the term. In 1964, Philip J. Gallagher in the Journal of Accountancy suggested that an accounting expert witness must be able to define the basic concepts of the profession and be able to explain accounting terminology.

Forensic Accounting and Investigative Accounting Come of Age

The Forensic Accountant Becomes an Investigator

Once accrual accounting took hold and the role of external auditor became much more broad based and control-oriented than transaction-oriented, there developed a need for a fraud auditor—a specialist who would ferret out deception in financial statements and reporting. Gradually the definition of forensic accounting expanded from the accountant who testifies in court to the investigative accountant as Peloubet chronicled. The forensic accountant learned to detect fraud itself, not merely to testify about it. Perhaps nowhere is this more evident than in the use of accountants and forensic accounting skills by the FBI.

FBI and Forensics

According to Lee R. Pennington, during the period of hostilities in WWII, the FBI employed a total of 500 agents who were accountants. In 1960, J. Edgar Hoover began to emphasize fraud detection. Agents investigated violations of the Federal Reserve Act, check kiting, embezzlements, fraud in government contracts, criminal investigations under the National Bankruptcy Act, various civil investigations, fraudulent check schemes, securities fraud, confidence game swindles, embezzlements, false bills of lading, fraudulent bankruptcies, false claims, and various frauds perpetrated against the government. Today there are more than 600 FBI agents with an accounting background, and many are CPAs. The FBI today has a Financial Crimes Section that investigates money laundering, Internet crimes, financial institutions fraud, and any other economic crime.

First Forensic Accounting Books in United States


AICPA Practice Aid

In 1986, the AICPA broke forensic accounting into two broad areas: investigative accounting and litigation support. The Institute issued Practice Aid 7, which outlined the six areas of litigation services: damages, antitrust analyses, accounting, valuation, general consulting, and analyses.

American Management Association Course

The American Management Association now offers a self-study course, "Forensic Accounting and Financial Fraud," which breaks forensic accounting into four broad areas: pretrial support, trial support, expert witnessing, and settlement support.
The Panel on Audit Effectiveness

The Public Oversight Board (an independent private sector body created in 1977) appointed the Panel on Audit Effectiveness in 1998 at the request of then SEC Chairman Arthur Levitt to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest. The Panel conducted the most exhaustive study ever undertaken of the audit model and on September 6, 2000, released a report of more than 200 pages entitled Report and Recommendations. The report’s goal is to foster more effective audits that improve the reliability of financial statements, enhance their credibility, contribute to investors’ confidence in the profession, and improve the efficiency of the capital markets.

AICPA Fraud Task Force Report


The AICPA takes the position that auditors are not required to carry out specific forensic procedures, but rather provide guidance on how to include forensic techniques within the SAS 99 process. Public accountants may need to use forensic accountants in certain circumstances.

Controversy Surrounding the Accountant’s Role in Fraud Detection

In the early 1980s, companies began to use computers to perform their record keeping, and intense competition caused the auditing fees to fall as much as 50 percent from the mid-1980s to the mid-1990s. Thus, auditors had to cut costs by reducing the labor-intensive process of reviewing hundreds of corporate accounts. They grew more reliant on internal controls and worked less with account balances and entries. Because top executives can circumvent internal controls, they could manipulate the records and cook the books.

Accounting experts debate the role of auditors in uncovering fraud and hold many different views. Some believe that every audit engagement should include much more skepticism and detailed review of transactions. Others suggest that only special engagements specifically targeting fraud can adequately and effectively root out the problem.

American Accounting Association Finally Permits a Forensic Section

A new Forensic and Investigative Accounting (FIA) section of the American Accounting Association was created in 2009 by Larry Crumbley. This FIA section is dedicated to the continual improvement of forensic accounting research and education, through the encouragement, development, and sharing of:

• The promotion and dissemination of forensic and investigative academic and practitioner research.
• The relevant and innovative curricula with an emphasis on effective and efficient instruction.
• The exploration of knowledge-organizational issues related to forensic accounting programs.
• The creation and presentation of CPE courses to members and professionals.

Conclusion

The computer helped direct a revolution in accounting because business transaction volume grew to such an extent that it was impossible for accountants to examine each transaction. Internal controls, determining risks, and sampling became the focus. Unfortunately, unethical managers learned to skirt the modern controls; thus, weaknesses in the modern risk control and sampling approach grew during the 1990s and became even more apparent in the first few years of the 21st century. For broad-based, system-wide relief from today’s financial scandals, many suggest that the weaknesses can be attacked successfully in repositioning the auditing engagement and mandating more stringent ethical and independence requirements to start.