

## Forensic Accounting

In early days, it was supposed that investigating and detecting white-collar transgression was a part of the general accounting function. Conventionally, it was the duty of either internal or external auditors to catch the frauds in an organization by performing periodic audits. It was however not the case to be. In fact, the auditors can only go by book and can check compliance of documents produced by the company to the general rules and regulations of the company. It was this bottleneck that brought forward the idea of a new branch of accounting to detect the fraud for companies that suspect fraudulent acts being performed in them. This area of accounting is known as forensic accounting. (FORENSIC ACCOUNTING DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

The specific field of accounting in which accounting, auditing and investigative skills are integrated together is called Forensic Accounting. The lateral meanings of term "Forensic" are "Belonging to, used in or suitable to courts of judicature or to public discussion and debate." Based on the above-mentioned skills, a Forensic Accountant provides an analysis that is appropriate for the judiciary to form the basis for discussion, debate and eventually resolution of affair. (What is Forensic Accounting?)

<http://www.forensicaccounting.com/one.htm#start>, Retrieved on 28/06/2003).

In a lot of ways it is fairly similar to the forensic field of the police department. In the fashion that they dissect the affairs and cases, similarly this branch of the accounting breeds accountants who are dedicated to the field of auditing and it is their specialty to understand the minutest details of the functions and the operations of any business. It is not only the business firms and multinationals, which need to use these services, but even the local and federal governments may need to hire the services of these forensic accountants.

It is not an entirely new field and has existed for quite sometime but the importance of the field has been growing over the years. The concept was promulgated right after the crash of 1929, October 22<sup>nd</sup> and it was then the need was felt to have a certain format of forensic accounting.

It was the era when the world was on the path to recovery and the nations were coming out of the impact of First World War, and while they were recovering the developmental projects were in full swing. During the period of chaos and anarchy United State's Economy was emerging as a leading economy and they were the hub of all the financial and economic activities. The banking sector over there was on the rise and they had the access to the funds that could be transferred to the European

projects. There were a number of developmental projects and people would go to borrow in US markets. They would often form companies and float them on the Stock Exchange and even borrow from the banks. These borrowings were backed by fictitious assets and in reality the projects just did not exist. There were no inquiries and people were releasing the money for these projects.

Once the people realized that the dividends were not forthcoming and the investments were sinking it became apparent that the people were very close to losing their moneys. People wanted to liquidate their investments in these companies and they went on a selling spree, which made the stock market collapse. Even the good companies lost a lot of share value. People who had deposited with the banks went to extract their investments and since the banks were short of money this meant that the banks went bankrupt within a span of hours. So the companies, the stock exchange and the banking sector all crashed in a single day and with it the trust and faith of the people was lost as well. The after affects were that the entire economy went into a slump and this slump lasted for almost a decade and engulfed the entire world in it.

This entire catastrophe had its roots in the ability as well as the inefficiency of the people to regulate the system. There were no checks and balances in place and as a result it

brought about such a big mishap and the aftershocks could be felt for years after the actual event had taken place. This is where the people began to feel that there was a need for a special field, which would oversee such activities, and at the end of the day the investments would be kept secure because there would be someone who would be dissecting the company accounts and would be revealing the truth behind the operations of any company.

Forensic accounting is a huge field. The companies, organizations, firms and multinationals have operations that are very overlapping and they run into a number of unknown and unexplored areas. That is why the process of running the audits and having a trial check or the checking of the affairs of the business from top to down is a fairly time consuming process. It does not take time because it is lengthy but it is lengthy because there are so many things and none of those things can be overlooked. There are the intricate details in the minutest of details of the business that contain a lot of information. These are the places where one may find the loopholes and the people are able to make their gains by bluffing the public.

As unethical as it may sound but this is where the concept of kickbacks and the bribes comes into the picture. People are willing to go to any length to ensure that they are not revealed. And they do not want to come out in the open because they are

either involved or ate part of something wrong in such a manner and of such magnitude that they have risked everything for it.

Forensic accounting is dedicated to finding the culprit before the act is actually committed. The idea is to find the guilty party before the actual sin. That is an arduous and grilling task and it requires a lot of effort. One can imagine how difficult it is to pinpoint an act of misdemeanor and then judge it, forecast something and predict that in the future something wrong is going to happen because of what was said or done or visible through the records of the company.

Within the Forensic accounting, there are two broad categorizations of areas of practice, namely

1. Litigation support specialists and
2. Investigative or fraud accountant.

Further sub-categorization of the litigation support accountant is the business valuation, revenue analysis, expert witness testimony, and future earnings' evaluation. In similar way, the investigative accounting has two specific areas; detecting evidence of criminal act and dispelling or supporting of damages. (FORENSIC ACCOUNTING DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

Business valuation is when the company is floating itself or is looking for funds from some third party. They can only

borrow funds from some third party on the basis of their credit worthiness. Besides that they need to show that they have ample worth of assets already in hand. This is especially important for floated companies. Every time there is an offering to the public of shares they have to let the public know what is their current worth and how have they fared in the past in terms of their asset turnover ratio and their debt equity ratios and so on. Earlier it used to happen that the records used to be manipulated and the public did not used to get the true picture. At the end of the day it was the common man and the plebians who were at the loss of money.

That is why the concept came to have the evaluation done by some third party. The auditors and the chartered accountant firms specialize in that. But even that we have had cases like Enron, WorldCom and other similar cases in the not too distant past. The evaluators had to ensure that they were diligent enough in their work and that did not happen in any of the cases.

Somebody probably said it best that it is in the hands of the accounts, accountants and the accounting practices to change the things for the better of the nation. They are in the position to change things and reveal them. If they reveal everything to its true potential people will to have anything to worry about and everything will be quite transparent. It is

when the people want to hide things they bribe these accountants and they end up altering the books for them. That is why at the end of the day there are fictitious assets and in turn it is the common public, which is at the loss, and the people lose money. Forensic accounting is all about helping the audit to go a step further.

This process of evaluating the true worth of the business is even more important when the business is up for sale. The interests of both the parties have to be taken care of and that is why the assets should not be overvalued nor should they be undervalued. It is an important exercise because of late the concept of mergers and acquisitions has been on the rise. Plus there has been this concept of leveraged and inward buyouts. For them to be financed properly and for such deals to go ahead it is imperative that the buyer knows what he is buying and the seller has to know what he is selling and the price has to be quoted in terms. That is why it is significant that the prices of shares can be determined properly and for the share prices to be determined properly one has to know the worth of the company as well as the earnings and the revenues and the debt ratios of the company. While the auditing companies are responsible for the ratio management of the companies the forensic accounting is concerned with determining the true worth of the company.

Similarly there is another field of that of revenue analysis. A business may have a lot of concerns and interests and there may be a number of subsidiaries and other sublets which are operational. So the revenues may be coming from a number of sources and there might be leakages as well as a number of expenses. That is why the analysis of the financial statement is very important for people who want to invest in such companies and it is the job of the accountants to reveal such information to the common public.

Revenues sources have to be judged and assessed. That means that one has to know what are the actual sources and what are the means of earning and how long will they last and what is their sustenance level and life in the longer run.

Then one has to know about the expense side of the financial statement especially on the income statement of the company. There may be a number of expenses and there may be a number of unnecessary expenses. For instances in a number of cases there are times when the people are spending too heavily on the business executives. These executives do not want the accountants and the auditors to reveal that it is these executives who are eating the hard earned money and return on the investments of the shareholders and on the efforts of the common labor. So they over burden the other expenses and in turn offload their own expenses on such fields and as a result the



financial statement suffer a setback and in turn it is the common man who is at the loss again.

Similarly it is a must that it is known what was the true potential of the earnings. The earnings have to be legit and have to be accounted for so that the public can know about and the auditors and the tax payers can also know where to charge and whom and with what amounts.

So basically the forensic accounting in this case complements and works hand in hand with the auditing wing of the accountants.

Most importantly there is this field of expert witness testimony and the forensic accountants carry that out too and that main job is not at all simple in this context. This is where they dissect the company to the fullest and are able pass their judgment and they render their opinion. This opinion is deemed to be worthy and many people think that they can benefit most from it. Many a businesses want to know about the forensic accountants' testimony because they believe that it will act as a true guide for them.

This expert testimony is not based on something personal but they simply use what they see around them. They study all of this and they go through it and then at the end of the day they are in a position to suggest where is the company headed. They

can know about it and they are in a position to predict the future of the company.

Their testimony carries a lot of weight in the sense that they are considered to be the professionals in the field. It is their specialty and it is assumed that whatever they will be saying will be the best. They do weigh their options and base their decisions on the expert testimonial of the forensic accountants. This minimizes the chances of frauds and people can take a sigh of relief and invest when and where they feel that it is of right nature and the people are supporting them as well.

Most importantly the government institutes can benefit most from the efforts of the expert testimony of the forensic accountants. They can be given a project to research on and a firm may be well and truly assessed and judged by them. They will dissect and study each and every minute details of the company and check for frauds and fraudulent behavior and when the government institutes such as IRS (Internal Revenue Services) they will be in a position to let them know the truth about the company. These government agencies rely on the work and the effort of such firms. There are a few things, which work to their favor. Firstly since they are private firms they do make a lot of money and at the same time it is their expert field and the way they are able to assess and judge the company

accounts nobody else is able to do so. They have the expertise, knowledge, know-how and the caliber to reveal the truths of such magnitude. That is why the culprits fear them and the nation, people and the government institutes want them. They know well that the forensic accounting solves half the work of the government officials if it is carried out properly.

Most unpredictable and the tricky part is the assimilation and the judgment future earnings' evaluation. This is another area the forensic accounting specializes in. on the basis of the past data and the past information they are able to tell the people what is the true worth of the firm. Since they can make out the trends in their actions, policies and the strategies they can also determine what direction are their share prices moving in.

Future earnings are what people are looking forward to and it is the future dividends or the future capital gains in the offering that makes a person invest in a certain company at the present time. Obviously no one would be willing to invest in a firm that is likely to go bankrupt six months down the road. But if someone knows that the in the future the IT sector will be booming and there will be more jobs and the incomes of the company will be growing by more than 200% that implies that the company will be becoming more profitable and in turn there will be more dividends for the end investors which in this case will

be the shareholder. It is not that difficult to assimilate but at the end of the day it is all about the future expectations and the predictions that can be made. People often undertake the gamble on the investments and they would be much rather be dead sure about their investment decisions. That can happen if the forensic accountants are able to predict the future growth and the incomes of the company.

But the again it is not only about being able to predict the incomes of the company but more about being able to tell what is the true status of the earnings of the company and whether they are telling the truth to the people or are they lying to the common public. They are trying to let the people know the reality behind any company. For a fraudulent company the reputation is at stake and they are vulnerable to losing everything. But at the same time the good company is in a position to gain everything.

So forensic science is not about giving benefits to those who need it but it is dedicated to exposing the black fishes in the sea. It is all about discovering the wrongdoings and the mishaps of the firms and letting the public know about it. Future cannot be predicted without knowing the truth of the present. Forensic accounting studies the true value of the present and the present stands on the basis of the past and that is why they assess the past as well and on the basis of that

they predict the future. This is the part, which makes the future income analysis and suggestion all the more important.

It is not only about numbers because the numbers may get tricky but it is about knowing and judging the true face of things. There are things, which are there, but we do not notice them and that is why they constitute to be fraud. The idea was that once such a science would be invented it would help preserve the sanctity of things and in the end the people will know that there is someone or a group of people who are dedicated to exposing these people and thus the chances of such fraudulent behavior would be cut down. Forensic Accounting may exist but what is more important is that how well is it executed and how well is it practiced.

Forensic accounting was introduced in the backdrop of ever increasing figures of white-collar crimes. There are limitations associated with law enforcement agencies to tackle such technical and covert frauds being done in organizations. Studies suggest that the mediocre level white-collar crime may amount to \$25,000 for a company and this amount can increase up to \$500,000 if aided by a computer at the disposal of the criminal. KPMG predicts that there is a large no. of such criminal acts being done and that justifies an independent unit engaged solely in this specific field of accounting. (FORENSIC ACCOUNTING

DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

What does it take to be a Forensic Accountant?

The qualification to become an entry level forensic accountant include some basic accounting skills as need by a good auditor as well as the aptitude to handle minute details with great care. It also needs to scrutinize the available data meticulously, have creative thirst, have a general sense to understand business ethics, be computer literate, and last but not the least have excellent communication proficiency. It is also recommended to have a sharp long term as well as short-term memory as it will help to make a correlation between present and past events. This is the skill as needed for a detective. The forensic accountant is also supposed to have a cool head, as this skill will be needed when detailing these events on the witness stand. Finally, a forensic accountant must be able not to lose his composure in the event of personal offense on his professional credibility, as this phenomenon happens too often during the course of investigation of fraudulent cases. These are the personal skills needed to be a good forensic accountant but there are also some formal qualifications needed to enter into this field. (FORENSIC ACCOUNTING DEFINED,

<http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

In order to get yourself accepted as an expert in this field, there are many degrees & certifications prevailing. Especially for Forensic accountants involved in litigation support or investigative accounting, they must have some form of credentials under their belt to consider themselves competent for the career they are interested in. There are two main professional certifications currently available after completion of the basic requirements for an undergraduate degree. These are namely the Certified Fraud Examiner (CFE) and the Certified Insolvency and Reorganization Accountant (CIRA). (FORENSIC ACCOUNTING DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

CFE is the first certification available to start the career as forensic accountant. The requirement of this certification is bachelor's degree in accounting as well as having two years of professional accounting experience. The CFE exam has four portions to pass before becoming CFE certifies. There are four sections of the exam: financial transactions; investigation; legal elements; and criminology. Each section must be passed within three consecutive sittings. Currently, the cost of the examination is \$200. (FORENSIC ACCOUNTING DEFINED,

<http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

The second certification available to the forensic accountant is the CIRA. Besides having bachelor's degree in accounting, the candidate must have at least five years of professional accounting experience. These five years must be spent in a public accounting firm. It is also required that about 4,000 hours must be consumed in bankruptcy and re-organizational accounting. The exam pattern for the CIRA is unique compared with any other certification in the accounting profession. The exam comprises of three parts. These are financial reporting and taxes; managing turnaround and bankruptcy cases; and plan development and accounting. The cost of each part exam is around \$500 and includes an actual course of study followed by an exit examination. Each section is registered for and attempted separately. (FORENSIC ACCOUNTING DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

Similar to other professions, the CFE and the CIRA are not the licenses to practice forensic accounting but rather an official recognition that a knowledge base required to qualify, as forensic accountant exists in the candidate. It requires the successful possession of CPA license to practice as a forensic accountant. The advantage of above two certifications is that a



forensic accountant may then look for many diversified different positions as that of fraud auditor and investigator, loss prevention professional, or litigation support specialist. Large companies are already encouraging these certifications by inducting these certified professionals in their organizations in order to address the needs of their clients. Moreover, many certified forensic accountants are hired by government agencies like the FBI and the IRS. The Association of Certified Fraud Examiners, a professional organization striving to reduce the occurrence of fraud and white-collar crime, states that the demand for the CFE and CIRA certified forensic accountant is projected to increase by a rate of about 100% per year. The average pay range of these forensic accountants is between \$70,000 - \$200,000 per annum. The increase in demand for forensic accounting is due to the increase in white-collar crime associated with society's extended computer literacy, as needed to handle ever-complicating private and business transactions.

(FORENSIC ACCOUNTING DEFINED,

<http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

There are two broad areas under forensic accounting, namely litigation support and investigative accounting. According to the definition provided by AICPA, litigation services is "any professional assistance non lawyers provide to lawyers in the

litigation process." (FORENSIC ACCOUNTANTS APPEARING IN THE LITERATURE,

<http://www.bus.lsu.edu/accounting/faculty/lcrumbley/forensic.htm>  
1, Retrieved on 28/06/2003).

In litigation support consulting cases, the forensic accountant is required to provide his opinion on the basis of known or covert facts and figures. In the case of covert cases, the accountant has to behave like an investigator or detective of sorts. In some other instances, he may be required to prepare his own model based on the extracted information as to how affairs should move on if done correctly. Key activity areas of litigation support services include engagements in both professional liability and civil claims. Further areas included in professional liability claims include computing the bearing of lost income from events such as construction delays, stolen trade secrets, insurance disputes, damage/loss estimates and malpractice claims. The civil claims may include business valuations, especially in events of divorce resolution, as well as employee theft and accident investigation. (FORENSIC ACCOUNTING DEFINED, <http://www.cris.com/~dfillmer/forensic.htm>, Retrieved on 28/06/2003).

As a matter of fact, the earning as litigation support is far more than any other specialization field of forensic accounting; the investigative or fraud accounting is another

exciting area of forensic accounting. The AICPA describes that an investigative accountant seeks for evidence of criminal conduct or support to determine or denial of claimed damages. They question seemingly minute details and peek for potential inconsistencies in these. (FORENSIC ACCOUNTANTS APPEARING IN THE LITERATURE,

<http://www.bus.lsu.edu/accounting/faculty/lcrumbley/forensic.htm>  
1, Retrieved on 28/06/2003).

#### Typical approach to a Forensic Accounting assignment

Although each forensic accounting assignment is a distinctive, however there is a generic approach to perform an assignment. General steps are;

##### Client Meetings

Essential step as to obtain important facts and figures to handle the case

##### Conflict check

A conflict check is performed as soon as the relevant parties are identified.

### Initial investigation

Very useful step! Preliminary investigation is important before making a detailed plan for investigation.

### To develop an Action Plan

This plan is prepared on the basis of information attained by performing the above first three steps.

### Obtain the relevant evidence

The nature of such evidence depends upon the nature of the case in hand. It may include finding some documents, getting economic information, assets, an individual or a company, another expert to help or proof of the happening of the even under investigation.

### Perform the analysis

The final analysis depends upon the nature of the case and may involve calculating cost of economic indemnity, scrutinizing many transactions, tracing of assets, utilizing a computerized application such as a spread sheet, data base or computer model, and making use of tables, charts or graphics to explain the analysis.

Prepare the report

A report is prepared which may include detailed description of the problem, findings, data and final recommendations. The report also includes schedules and graphics necessary to properly support and explain the results. (What would be a typical approach to a Forensic Accounting assignment?

[http://www.forensicaccounting.com/four\(5\).htm#start](http://www.forensicaccounting.com/four(5).htm#start), Retrieved on 28/06/2003).

#### Some Cases handled by Forensic Accountants

A recent study by the Association of Certified Fraud Examiners reveals that an average organization loses about 6 percent of its total annual income to frauds and abuses committed by their own employees. That amounts to an average of \$9 a day per employee. (Forensic Accounting: Your Secret Weapon Against Fraud,

[http://www.investigation.com/newsletter/1n\\_2/newsletv1n2\\_1.htm](http://www.investigation.com/newsletter/1n_2/newsletv1n2_1.htm), Retrieved on 28/06/2003).

There is always growing demand of forensic accountant around the world. As described above, there are a number of certifications available to get into the trade and have a title of forensic accountant. However, the most important aspect of being a forensic account, like any other professional field is not to have a title with your name but to have a practice of the

same. The excellence in practice of handling cases comes with experience. It is also advisable to have a mentor to nurture your raw talent.

In a case handled by Michael G. Kessler & Associates, a major food forgery and repackaging operation in Brooklyn was exposed. The Kessler's investigators, accountants and computer experts, together with U.S. law enforcement agencies and legal representatives detained the product, forged packaging materials and computer and financial records from eight different locations. The invasion was due to a detailed and painstaking investigation by Kessler, the Forensic accounting group. After the legal capture of warehouses, Kessler's Forensic Accountants searched the suspect company's documents and discovered that the owners of these companies were earning millions of dollars annually by engaging in such illegal activities. Such illegal activity badly affected more than twenty big corporations and also brought bad names to the name of these companies. The fraudulent companies were involved in using the trademark of such large companies as well as the tampering the lot of codes and expiration dates on a number of different food products.

(Forensic Accounting: Your Secret Weapon Against Fraud, [http://www.investigation.com/newsletter/1n\\_2/newsletv1n2\\_1.htm](http://www.investigation.com/newsletter/1n_2/newsletv1n2_1.htm), Retrieved on 28/06/2003).

In another case study, the background was a civil trial, a criminal investigation, and the lack of sufficient proofs upon which a decision could be based. The forensic accountant was asked to compute the loss incurred as a result of an armed robbery. The loss was having two parts. First was the value of the stolen goods. The second part was the damage caused by this robbery resulting in interruption of business. (Valuing Economic Damages after an Armed Robbery, [http://www.hbscpa.com/forensic/art\\_robbery.html](http://www.hbscpa.com/forensic/art_robbery.html), Retrieved on 28/06/2003).

The robbery was faced in downtown Los Angeles of concentration of jewelry vendors commonly known as the "Jewelry Mart." There are many large buildings in the close proximity, where small manufacturers were sitting in rented shops within the mart to display their wares and conduct business. The vendors used to either take their inventory with them or store it on site, in a safe location within their rented shop. (Valuing Economic Damages after an Armed Robbery, [http://www.hbscpa.com/forensic/art\\_robbery.html](http://www.hbscpa.com/forensic/art_robbery.html), Retrieved on 28/06/2003).

An armed robbery took place in one of these buildings. The circumstances later revealed that the act was well thought after and executed well according to the plan. Four armed men evidently were hiding overnight inside the building to escape

from detection and effectively bypass existing security systems. As a routine, the caretaker came into the building accompanied by a security guard early the next morning. The armed and disguised impostors were waiting, attempted to assault the janitor and security guard. The victims were later found handcuffed in the restroom. (Valuing Economic Damages after an Armed Robbery, [http://www.hbscpa.com/forensic/art\\_robbery.html](http://www.hbscpa.com/forensic/art_robbery.html), Retrieved on 28/06/2003).

The forensic accountant was asked to compute the damages. The forensic accountants after detailed analysis concluded that the amount of the loss during the period after the robbery was the gross profit that would have been generated by the stolen inventory. This conclusion was based on the short set up time, non-applicability of overhead during the loss period, and the ease with which the vendors were able to replace the lost inventory. It would have been traditional to calculate losses by projecting sales trends leading into the loss phase and establishing the effect of the event on not only sales but sales growth as well. The unusual circumstances of this case dictated a different conclusion. Finally, the forensic accountants' conclusions were accepted and the case settled without going to trial. In the final analysis, this is the ultimate objective of forensic accountant in litigation: present such a well poised case that both parties agree to settle before wasting the time



and financial cost of a trial. (Valuing Economic Damages after  
an Armed Robbery,

[http://www.hbscpa.com/forensic/art\\_robbery.html](http://www.hbscpa.com/forensic/art_robbery.html), Retrieved on  
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