

MSC Forensic Accounting

Fraud - Financial Investigation & The Role of a Forensic Accountant



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1. Introduction

In recent years, the increase in economic crimes has been pretty dramatic. Major cases have been reported in the world's media and sadly, the results of these cases have been damaging to both well-known organisations and individuals.

Such reports of financial crime have prompted companies to devote increasing attention and financial resources to the areas of fraud prevention and detection. This has also driven the impetus for the development and expansion of investigation services by financial experts.

In the accounting profession, there is a particular area in which the integration of accounting, auditing and investigative skills is required. This field, which is known as forensic accounting, is seen as the fastest growing discipline within the profession, and is an area that professionals are concentrating on when looking at developing their client service offerings.

Forensic accounting concentrates on a multitude of different areas ranging from matrimonial divorce to large-scale frauds. Over the past decade, there have been a number of well-documented and publicised business failures. The collapse of energy giant Enron and that of telecoms powerhouse WorldCom, are well known from the United States, and similar incidents of financial mismanagement have occurred in the UK, with the collapse of firms such as Equitable Life and telecoms provider Marconi.

The purpose of this paper is to review the process of fraud investigation, looking at the role a forensic accountant performs. I will concentrate on a number of key skills an investigator requires, paying particular attention to being an expert witness in financial crime investigations.

The focus will primarily be on the business world and the forensic accounting techniques discussed are central to the discovery of fraud in this environment. I will analyse this particular role and finally form a conclusion on the benefits of using the financial expert in financial investigations. As most of the academic writings on this subject are centred on US businesses, my paper will be mostly covering this locale.

2. Fraud

2.1. What is Fraud?

The early part of the 21st century saw the two largest bankruptcies in United States history. The Enron scandal, which occurred in December 2001, was shortly followed by the collapse of WorldCom in July 2002, and both of these scandals were the result of corporate mismanagement and accounting malpractice.

Whilst the overall cost of the WorldCom fraud was far greater, Enron had the most significant impact on the business community. This was due to the fact that it also led to the demise of the accounting firm, Arthur Anderson, who were convicted of obstructing justice by shredding documents relating to their audit of Enron.

The Enron scandal led to the creation of the Sarbanes -Oxley Act (SOX), passed in 2002 by US congress, and this alone brought the professions of fraud auditing and forensic accounting to the forefront. The SOX act has also had a major impact on UK firms as many have links with companies in the United States, including IT firm Electronic Data Systems (EDS) and insurance company Aon Limited. Working with these firms, I have seen the changes in its financial management and procedures since the advent of SOX.

These recent accounting scandals, along with many others reported by the media, have put accountants in the public spotlight as never before. For several months in early 2002, the American media provided an insight into the world of Enron, showing accountants giving congressional testimony or making court appearances.

Fraud is an activity that affects society. Silverstone and Sheetz (2007, p3) believe that fraud can have severe consequences for the economy, corporations and individuals. The Association of Fraud Examiners (ACFE) defines occupational fraud as "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organisations resources or assets".

This immediately draws your attention to the fact that such frauds encounter a financial impact, and this is endorsed by Golden, Skalak and Clayton (2006, p1), who argue that 'a central outcome in fraud cases is that of financial loss'. This viewpoint is justified when you consider the amount of money lost to fraud cases identified in a recent study carried out by the ACFE.

The ACFE study was conducted between January 2004 & January 2006 and focussed on 1134 occupational frauds in the United States. In its report of findings, published in July 2006, it found that the surveyed organisations lost an estimated 5% of their annual revenues to fraud. This is actually down on the previous report of 2004, in which the participants estimated losses of 6% of annual revenue.

As can be seen in the graph below from the ACFE's 2006 report, almost a quarter of fraud cases resulted in losses of at least \$1 million, with nine cases reporting losses of \$1 billion or more. However, any loss to fraud, be it \$1 or \$1 billion is the result of criminal activity.



Using the figures from the 2006 report, and applying them to the 2006 Gross Domestic Product of the United States, the ACFE estimated that this would equate to approximately \$652 billion in fraud losses in the US, which is a truly astonishing figure.

Michael Kessler, president and CEO of Kessler international, a leading US forensic accounting and investigation firm based in New York, declared in 2001 that "Fraud can sometimes be the difference between a company posting a profit or a loss". This is an interesting and quite valid viewpoint, especially when taking into consideration the ACFE's findings and shows the severity that fraudulent activity can have on businesses today.

Kessler International surveyed a number of leading businesses in the United States in 2001, and found that over two thirds of companies had used the services of a forensic accounting firm or were considering doing so in light of reported national financial malpractice. A criticism of Kessler's survey however, is that they did not publish the exact number of companies this study related to, which makes it difficult to put credence on the findings. Nevertheless from this statistics, it is evident that fraud is a major worry in today's business world.

2.2. Fraud Activity

Golden, Skalak and Clayton (2006, p157) declare that fraud is the outcome of one from two dishonest activities - fraudulent financial reporting or misappropriation of assets. There are a number of differing types of frauds, and of these, Silverstone and Sheetz (2005, p6) believe the most common is that known as 'white collar' fraud.

This particular kind of fraud involves intentional deception by the employees of an organisation, be they an office worker, manager, or director, but can even include vendors or customers. It is usually committed by individuals embezzling funds, manipulating accounts, or taking bribes at their place of business.

The Enron case is a prime example of this, where its chief accountant, Andrew Fastow, was charged with money laundering and conspiracy following the company's collapse. The BBC reported in 2002, that Fastow was alleged to have created and managed a 'complex web of partnerships that disguised the true state of affairs at the disgraced firm', and made a personal fortune in kickbacks from this operation.

Interestingly, according to Croall (2001, p5) white collar crime has not been subjected to as much research as other types of crime, yet it is seen as one of the fastest growing, greatest loss bearing criminal activities. However, in light of the recent large scale cases such as Enron and WorldCom, more and more consideration is being put towards this particular area.

Silverstone & Sheetz (2007, p15) depict that financial fraud is committed usually by a typical perpetrator – someone who is experienced in business, has reached a position of trust, and most importantly, is in a position where they have the *ability* to commit such a crime. This viewpoint is endorsed when you consider the perpetrators of the Enron and WorldCom frauds, all of who were senior figures in the company.

As mentioned earlier in the paper, economic crime affects society and is seen as a major social problem, although the consequences of these crimes are not fully understood by the general public. Perhaps that is down to the fact that the majority of the public do not show much of an interest in business matters unless it has a direct effect on them?

2.3. Fraud Investigation

Once fraud activity has been identified, it is then necessary to investigate the activity further. There are four typical phases to fraud investigation. These being:

- Planning
- Fieldwork
- Assessment
- Reporting

Dependent on whether a fraud has actually taken place will depend on the work required in each phase. For example, fraud investigators are regularly engaged to review the policies and procedures of an organisation to identify possible weaknesses. Identifying these weaknesses will assist an organisation in preventing a fraud occurring.

The table below is drawn from the ACFE Fraud Tree, and is a model that identifies the characteristics of three major categories of fraud – these being financial fraud, asset misappropriation and corruption, and is used when working on fraud audits, investigations and fraud prevention schemes.

Descriptors	Financial Fraud	Asset Misappropriation	Corruption
Fraudster	Executive Management	Employees	2 parties
Size of the Fraud	Largest: \$1-258 million	Smallest: \$93,000	Medium: \$250,000
Frequency of The Fraud	Least often: 7.9%	Most often: 92.7%	Medium: 30%
Motivation	Stock Prices, bonuses	Personal Pressures	Challenge, business
Materiality	Likely	Unlikely	Depends
Benefactors	Company and Fraudster	Fraudster (against company)	Fraudster
Size of victim company	Large	Small	Depends

Table 1 – ACFE Fraud Model: Unique Characteristics of Each Category (Singleton et al, 2006, p100)

This table identifies the typical perpetrators, potential losses, and reasons for fraud taking place, and has been adopted by many organisations. It was first used in the 1996 ACFE report to the nation and provides investigators with key information of model frauds and when used alongside the fraud tree, it is a useful tool.

Unfortunately, many organisations do not have the foresight to implement adequate controls until a fraud has actually taken place. When this occurs, the organisation will contact a forensic accounting company with the brief being to identify the perpetrator(s) and attempt to recover damages.

The use of a forensic accountant will assist an organisation in the investigation into financial malpractice. In the following section I will look at the exact role of a forensic accountant and detail what input they have into a financial investigation.

3. Forensic Accounting Defined

3.1. What is Forensic Accounting?

In 1817, at the Meyer v Sefton bankruptcy hearing, the trial judge allowed an expert witness to testify following his examination of the bankruptcy accounts. Crumley deems this the first instance of a forensic accountant in history, and as such, the beginning of the forensic accounting profession.

However, forensic accounting is seen as a relatively new, popular and fast growing area in the accountancy profession. There are numerous situations, which would benefit from the use of a forensic accountant, and the involvement of a forensic accountant is almost always reactive. So what does it actually entail, and what role does a forensic accountant perform in the investigation of financial crimes?

Forensic by its very nature refers to the law, and is defined by the Collins Gem English Dictionary (2004) as 'used in or connected with courts of law'. In simplistic terms, forensic accounting includes any accounting engagement in support of a legal case.

According to Manning (2005, pV) forensic accounting in its basic form, is classed as 'the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes'. Essentially, it is for a forensic accountant to dissect crucial financial information and provide it in a format that is easy to understand.

Sometimes referred to as a litigation support accountant (Winch, 2007, p1) a forensic accountant takes a more hands on, cynical approach in the examination of financial information, and makes no assumption on the integrity of an organisation or its management.

Typically, forensic accounting assignments involve valuations of businesses or fraud investigation. The valuation of a business is usually required when the ownership of a company changes or there is a disruption in the business. However, it can also be required for a number of other reasons, which include:

- Matrimonial proceedings
- Personal injury
- Insurance claims
- Patent or copyright issues
- Breach of contract

Alternatively a forensic accountant might be used by a solicitor in civil or criminal proceedings in relation to alleged crime or proceeds of crime. What is a common theme through all forensic accounting assignments is that all the situations involve financial disputes or fraud.

At first sight, accounts may seem to be unquestionable statements of truth - but not to a forensic accountant. Winch (2007, p26) believes that a good forensic accountant has the ability to identify that figures that appear to be 'black and white' but which may be compiled on the basis of unreliable estimates and questionable opinions.

In such cases, chances are that there will be reams and reams of accounting records or data to wade through. To an untrained eye, any discrepancy may be difficult to find. This is when the services of a forensic accountant can be invaluable.

A key trait of a forensic accountant is that of being able analyse, interpret, summarise and present complex financial and business related issues in a manner, which is understandable to a layperson. Drawing on various resources at their disposal, a forensic accountant will attempt to obtain relevant financial evidence, and from this, interpret and present the evidence in a manner that will assist both parties.

3.2. Why use a forensic accountant?

So why are the services of a forensic accountant required? There are many situations when the use of a financial expert would be beneficial. Generalising these situations, a forensic accountant is needed when there is potential perceived loss, real financial loss, or risk of loss (Singleton et al, 2007, p45)

Accounting related matters cover reconstructions of financial elements of a transaction, how such transactions were and/or should have been accounted for, and the effect of those transactions and their accounting treatment. The tasks that a forensic accountant can be involved in include:

- Investigating the case
- Gathering evidence
- The preparation of a clear, well structured report
- Discussions with the opposing side's expert, and if necessary
- Giving oral testimony in Court

The significant amount of documents and evidence referred to earlier are likely to be extremely number intensive, and as such require analytical skills not ordinarily found amongst solicitors and barristers. A forensic accountant has the ability to provide a 'professional, objective and independent opinion on matters within his field' (Winch, 2007, p1).

Forensic accountants have been conducting these activities for quite some time, but new laws and regulations resulting from the high profile Enron and WorldCom scandals has made the role of the forensic accountant more important than ever before in today's business world.

By utilising their accountancy skills, a forensic accountant can work to the detailed instructions of the lawyers to collate and analyse evidence. They will then draw appropriate conclusions and can present those conclusions in writing and in person at trial in a format that would be understandable to a jury.

Golden, Skalak and Clayton (2006, p22) believe that the findings and recommendations of a forensic accounting investigator may form the basis of

testimony in litigation proceedings or criminal actions against the perpetrators, and therefore form an integral part of the investigation.

4. A Forensic Accountants Role in Financial Crime Investigations

4.1. The Forensic Accountants Role

Silverstone and Sheetz (2007, p63) argue that accounting professional's play two important roles in forensic investigations, these being 'lead financial investigator' and 'expert witnesses' in court cases. It can be argued that they perform a wider function than this, but for the purpose of this paper, I will concentrate on these two areas.

When it comes to investigating financial crimes, a forensic accountant can provide the necessary support towards the investigation, and is trained to look beyond the numbers and deal with the business reality of a situation. They can make significant contributions to the investigation providing that they are allowed to work effectively with the organisations auditors, be they internal or external.

A forensic accountant will be brought into an investigation a little later than a fraud auditor and in basic terms, it is their responsibility to 'translate complex financial transactions and numerical data into terms that ordinary laypersons can understand' (Singleton et al, 2006, p5).

In engagements involving financial crimes, the investigator will examine procedure manuals, interview personnel and observe the various processes. The outcome of this investigative work will be to produce a report, which identifies and describes the unforeseen weaknesses. It will also highlight which policies or procedures are not being followed and potentially recommend corrective action to resolve.

During the investigation, the forensic accountant will identify evidence of financial crime, collate and quantify the information and from this, action can be taken against the offender, be they an individual or an organisation. Working alongside other investigative bodies, a forensic accountant has the knowledge of what to look for to identify unusual patterns of activity .

Manning (2005, p22) illustrates that in addition to having the specialised knowledge and the use of techniques to identify fraud, a forensic accountant requires a patient

and analytical mindset. This provides the ability to 'look beyond the numbers and grasp the substance of the situation'.

Patience is a key skill for a forensic accountant as they could be required to spend a painstaking amount of hours reviewing documents and balance sheets, looking for inconsistencies for example.

Winch (2007, p27) argues that the selection of a good forensic accountant is paramount to the success of an investigation. By bringing a variety of skills to the table, such as interviewing, analysis and data mining (Golden, Skalak & Clayton, 2006, p259), a good forensic accountant is much more than a good accountant.

Acting with integrity and respecting confidentiality are key skills needed in accountancy, but on top of this, a good forensic accountant needs to have a good aptitude for work.

Smith (2007, p1) also states that an inquisitive mind, tenacity and attention to detail, excellent communication skills and the ability to communicate at all levels are essential and most importantly, is the ability to work with large amounts of evidence while working to tight deadlines.

4.2. Expert Witnessing

A forensic accountant is often thought of as an auditor, but the role goes much further than just audit. The main distinguishing feature between an auditor and a forensic accountant is the role played once the investigation has taken place. The conducting of an audit is basically as far as an auditor will go in the investigation.

However, a key area for a forensic accountant investigator is that of being summoned as an expert witness for cases that go to court. According to Gerdts and Dixon (2001), this expert testimony is admissible at a trial if "it is relevant to the determination of fact at issue, is presented by a witness qualified as an expert and will assist the judge or jury in understanding the evidence".

So what is an expert witness? Covering many different areas, an expert witness is someone who is skilled in a particular field, and has experience and/or knowledge in regard to matters not commonly known to the ordinary person (Manning, 2005, p204). An 'expert' can provide an analysis based on his or her professional opinion.

Taking it a step further the expert witness has a responsibility to provide an opinion or answers to hypothetical questions posed by the court. It is key to note however, that a jury are not obliged to take the opinion of an expert witness, and it is entirely their decision whether to use any of the information provided as weight to an argument.

In cases that are held before a court, only professionals are allowed to give testimony consisting of opinions, conclusions and characterisations that are deemed legal (Singleton et al, 2006, p255). When called as an expert witness, it is usually to testify about investigative findings. Obtaining an expert opinion from an experienced professional forensic accountant can carry substantial weight in court cases.

For example, when called by the defence, the testimony may be in regard to the quality of the findings or opinions expressed by the prosecution's accounting expert. This is to assist the defence in questioning the information provided by the prosecution's expert and to place doubt in the minds of the jury on its credibility,

The goal of a forensic accountant is to make their findings understandable to counsel, judges, and juries (Singleton et al, 2006, p264). The most important element of being an expert witness however, is that of being a *credible* expert witness

The credibility of a financial expert has come under more scrutiny since the passing of the Daubert case standards in 1993 (Silverstone and Sheetz, 2006). These standards resulted from the Daubert v Merrill Dow Pharmaceuticals Inc. case. In this case, the client was able to defeat the pleadings of the expert witness counsellor because the evidence presented on sexual abuse was opinion based, without having any valid and relevant material scientific foundation to support the evidence or purported allegations.

The Daubert standards form a basis on determining the expert's qualifications and the credibility of their testimony. Following this case, judges were provided with the responsibility to dismiss unreliable expert testimony if it did not meet a particular standard. Daubert was one of the most important decisions in US case history, and in simplistic terms stated that all expert testimony must be based on scientific foundation and not simply an opinion.

This ruling created problems for the forensic accountant, as the testimony provided in this field is classed as non-scientific. Forensic accountants need to be careful if they are to meet the Daubert challenges. Since the advent of the standards, many testifying experts have been subject to challenges by opposing counsel in an attempt to prevent an expert from testifying (Singleton et. al 2006, p260).

An example of this, cited by Singleton et al, was seen in the Andrew Whelan et al v Tyler Adell et al case, where the judge discounted the financial valuation testimony of the forensic accounting expert. The expert used only one valuation method, which relied on speculative financial projections. In Target Marketing Publishing Inc v ADVO inc., a similar outcome occurred.

Singleton et. al. describe how following the Daubert ruling, Crumbley, a pioneer in forensic accounting, provided some helpful points for the financial expert. To ensure their credibility, a forensic accountant should review their qualifications and make sure that they have the necessary competencies to serve as an expert witness in a particular case.

They must also get their credentials in order; after all, they are required to disclose their identity, the issues their opinions will address, their professional qualifications and who is paying them. Failure to provide up to date and honest credentials will immediately put doubt on the credibility of the expert.

Most importantly however, the forensic accounting expert must be realistic about whether they are right for the case, and if so, prepare in depth for the testimony. Appendix one shows an extract from the Regina v Scheel case, which shows the expert witness being questioned on their qualification to be an expert witness. This gives an indication of the kind of initial cross-examination an expert will face.

Smith (2007, p1) argues that a good forensic accountant should be able to prepare a robust, well thought out report, and support it with documentary evidence. However, more often than not, poor reporting, with limited or a lack of evidence to back up the findings, can result in the incorrect result. Therefore, how often an accountant has given evidence is not necessarily a good measure of their efficiency.

For example, in civil disputes such as business related ones, divorces and losses of profit claims, the majority of these are settled out of court. Due to the advent of alternative dispute resolution methods such as mediation, the number of required court appearances by accountants has reduced significantly (Smith, 2007, p1).

In these instances, court attendance is not required, but does that mean the forensic accountant would be a lesser expert witness? No it does not, but its certainly worthwhile noting this fact when looking to appoint the right forensic accountant as an expert witness.

4.3. Selection of a Good expert witness

The use of a financial expert is sometimes essential to the success of a case and these proficient individuals are required to meet high integrity and professional standards. It is crucial that the witness has the appropriate work experience and technical skills to convey relevant facts in relation to the case on which they are providing evidence.

According to Smith (2007, p1), a question regularly asked of the financial expert is 'How many times have you given witness evidence?' Expectation is usually that the higher the answer, the more experienced the accountant is as an expert witness. However, this is not necessarily the case.

Experience of being an expert witness is essential no doubt, but the most important element of expert witness selection is to obtain the right expert for the right case. This is a skill in its own right and crucial to getting this right is to select your forensic accounting expert as soon as a need for them has been identified.

This is key; as to get the best service from a financial expert you need to instruct them as early as possible. Vogel (2007, p29) believes that if you leave the selection of the expert until the last moment, then you will have problems finding a suitable professional.

This is certainly true in most instances – it is critical that the expert is given adequate time to understand, and research the case, whilst having the available time to formulate their expert opinion. It is likely that even the most qualified expert may be challenged under the Daubert criteria, so it is vital that the expert is given adequate time to prepare (Weil, Wagner and Frank, 2001)

However, Vogel argues that the client should never choose his or her own accountant as the expert witness. This would leave them open for a torrid cross - examination in court. Independence is the preferred solution here, and it is not difficult to understand why.

There are organisations that you can refer to in your search to find a good expert witness. The Network of Independent Forensic Accountants (NIFA), the Academy of Experts and the Expert Witness Institute check and accredit experts by obtaining references from solicitors or barristers that have used the expert's services. This provides some comfort regarding the expert's ability.

The right forensic accountant can play a vital role in assisting the instructing solicitor to quantify the amount of money that is missing or being claimed. However, care must be taken to ensure that expert forensic accountants are aware of their responsibilities and are capable of producing a report that will assist the court in reaching a decision. It is essential to provide a brief at the outset, and define specific objectives.

Since forensic accounting involves the reliance on many business documents such as bank records, accounting records and associated statutory records, how these documents are used in the presentation of evidence is central to the Court's comprehension of the underlying transaction itself and associated issues.

According to Winch (2007, p1) solicitors often appear to be reluctant to use a forensic accountant. This is even apparent in cases where the use of a forensic accountant might 'significantly strengthen their client's case or undermine that of their opponent'.

The forensic accountant may be called on by the court to give a different opinion on one reached by an equally credible expert accountant on the other side. This can arise due to different interpretations of the facts presented, or because of differing accounting techniques that may have been used.

In some instances, when equally plausible alternatives have been presented, the deciding factor in the case can be who has the most credible witness. This is why the selection of such a witness can be the difference between winning and losing a case.

5. Conclusion

The importance of financial experts cannot be underestimated, and the forensic accountant performs an ever increasing, important role in today's business world. Due to the nature of most financial crimes, the need for this kind of role will continue to grow.

Successful forensic accountants know the characteristics of fraud schemes and understand how they are perpetrated, and this enables them to perform their investigation or fraud prevention programs very well. A forensic accountant plays an important role in the criminal investigation, and expert witnessing is an integral part of the case.

Being an expert witness is a key attribute of a forensic investigator and it is essential that they are suitably experienced and qualified to provide this service. The list of retained experts is growing as the need for investigative services increases.

It is more desirable to prevent fraud than to suffer from it after it occurs. Investment in prevention and detection methods is paramount in the fight against worldwide occupational fraud. Unfortunately, due to the complexities of the world of business, coupled with the inventiveness of white-collar criminals, the chances are fraud cases will continue to rise.

In the future, forensic accounting investigators will still be required to investigate, cases will continue to be put before a court for prosecution, and regulatory bodies will bring out more requirements. However, at the moment, the sophisticated methods used by criminals means they are usually one step ahead of the game, and sadly, the occupational fraud refuses to go away.

What is certain however is that forensic accountants will do their best to fight against this worldwide issue, and should further scandals such as Enron be revealed, then they will help the victims in recovering their losses.

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