



Essentials of Forensic Accounting

Second Edition

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To my wife, Joan, and my late mother, Rita.
Mike Crain

To my friends, family, and colleagues.
William Hopwood

To my wife, Linda; my son, Justin; my daughter, Brittany; and my mother, Rebeca.
Richard Gendler

To my wife, Sherry; my sons, Joshua and Angelo; and my late parents, George and Wilma.
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PREFACE

Forensic accounting is a fascinating field of study and practice, encompassing knowledge from accounting, finance, law, psychology, criminology, and other disciplines. It involves the collection and evaluation of evidence, whether the forensic accountant is performing a fraud examination, providing litigation services, serving as a testifying expert or non-testifying consulting expert or determining the value of assets and liabilities. Forensic accountants can serve in a variety of roles, such as the prevention and detection of civil and criminal fraud, measuring economic damages in litigation matters, valuing business or intangible assets, and testifying as an expert in courts of law. Regardless of the particular service performed, forensic accountants generally need a diverse skill set, including the ability to think critically, use quantitative methods, conduct research and investigations, and communicate effectively.

The need for forensic accounting has existed for more than a hundred years and is now as important as it has ever been. One prominent area of forensic accounting is fraud prevention and detection. A reason for the ongoing need for forensic accountants in this area is that there will always be individuals who wish to exploit or gain an unfair advantage over other people. A second reason is that the world has changed in ways that facilitate the exploitation of others. For example, the proliferation of technology has made the perpetration of financial crimes easier and has decreased the risk of detection for the perpetrator. No longer do bank robbers have to physically appear at a bank with a gun to steal money; now they can sit in the safety of their homes and, with a few keystrokes, be unlawfully or unfairly enriched. On the other hand, technology is a tool in the arsenal of forensic accountants that can be used to expose many frauds. A third reason is that various markets have become increasingly complex. In these markets, financial assets, nonfinancial assets, and the structure of transactions have grown in sophistication and increased the demand for valuation services. In addition, the increased complexity of financial transactions has created opportunities for unscrupulous individuals to commit financial statement fraud.

To uncover fraud schemes, forensic accountants need knowledge of financial transactions, how they are recorded, and an awareness that fraud cannot always be found in business records and financial statements. They also need knowledge of types and sources of evidence, the process of evidence collection so as to preserve the chain of custody, and applicable laws and regulations. Also, forensic accountants must be able to think critically so they can assess situations, persons, and evidence to ensure that victims, to the extent possible, are made whole and fraudsters are brought to justice. Knowledge of forensic accounting can be used to recommend preventative strategies and measures that decrease the probability that fraud will be committed and increase the likelihood of early detection if it is committed.

Besides fraud investigation, forensic accountants engage in a wide variety of litigation services that include serving as a litigation consultant, expert witness, mediator, arbitrator, and bankruptcy trustee. Further, these services can involve many specialty practice areas. Examples of these specialty areas include due diligence in mergers or acquisitions, valuation of economic losses, the ability to resolve patent disputes, and assistance in the administration of estates and trusts. Business valuation is an especially broad practice area because almost any type of litigation or potential litigation can involve valuation issues. These issues include, for example, the value of intangibles in business acquisitions, asset values in divorce, economic damages in breach of contract cases, the value of complex options, and the value of businesses.

When measuring economic damages and business valuation, forensic accountants generally need a variety of knowledge and skills such as financial analysis, finance, economics, industrial organization, critical thinking, and good communication techniques. On many occasions, these kinds of services are needed for matters in dispute that may be decided by triers of fact, such as a court of law or an arbitration panel.

This book focuses on methods, techniques, strategies, and thinking processes utilized in forensic accounting along with professional standards of practice, ethics, and law applicable to subfields in forensic accounting. When appropriate, this book encapsulates information from AICPA professional standards, practice aids, and other AICPA publications. It consists of three major sections. Section I introduces the forensic accounting profession. Section II provides a thorough coverage of relevant legal issues and the practice of forensic accounting. Section III covers various forensic accounting areas, including fraud, bankruptcy, digital forensics, matrimonial forensics, economic

damages, and business valuation theory and applications. The overall coverage is consistent with the Content Specification Outline (CSO) for the Certified in Financial Forensics (CFF) examination at the time of our writing. Practitioners seeking the CFF certification may find our text useful when preparing for the exam. This book also expands on the CSO in many places, especially in the areas of digital forensics, expert witnessing, practice development, and fraud management.

The discussions about AICPA literature in this book are from the AICPA's perspective; other organizations, such as state boards of accountancy, may adopt AICPA requirements as necessary for their own licensees or members. Thus, licensed CPAs in certain states should be familiar with the requirements of AICPA literature, especially if these requirements are codified into state law.

Essentials of Forensic Accounting is designed for experienced and inexperienced forensic accounting practitioners and students who desire to enter the forensic accounting profession, as well as those who simply wish to know more about the comprehensive body of forensic accounting knowledge. Because the text covers many areas, it does not encompass the entire body of knowledge of particular topics. Some readers may peruse certain chapters and others may use the material contained in these pages as a springboard for the study of the various professional standards and AICPA practice aids. Extensive end-of-chapter materials make the book suitable for instructors and students of college and university courses that involve forensic accounting and fraud examination at the undergraduate and graduate levels. We hope that this book helps you understand the uniqueness of this fascinating area of study and encourages you to learn more about forensic accounting.

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SECTION I

Introduction