

Forensic Services, Audits, and Corporate Governance: Bridging the Gap

DISCUSSION MEMORANDUM

EXECUTIVE SUMMARY

In audits conducted in accordance with generally accepted auditing standards (GAAS) or the standards of the Public Company Accounting Oversight Board (PCAOB), auditors have a responsibility to plan and perform audits to obtain reasonable assurance that the financial statements are free of material misstatement, including material misstatements caused by fraud. Corporate frauds and audit failures at Enron, WorldCom, and other companies have further increased public focus on fraud, and the public is demanding greater vigilance from all parties involved in organizational governance. As a result of the passage of the Sarbanes-Oxley Act of 2002, audit committees of publicly traded entities not only are responsible for the appointment, compensation, and oversight of independent auditors but also are required to establish a system for the receipt, retention, and treatment of complaints received by the issuer. Further, they have been given authority to hire advisers, funded by the issuer, to carry out their duties. Independent public accountants and internal auditors will continue to serve important roles in the process. Forensic accountants have emerged, however, as vital allies in the fight against fraud. Forensic accountants with appropriate education, training, and experience can provide additional assistance to audit committees and financial statement audit teams so they may better carry out their responsibilities.

While many definitions exist for the general term forensic¹, the AICPA's Forensic and Litigation Services Committee (FLS) believes that forensic accounting consists of two major components: litigation services that recognize the role of the CPA as an expert, consultant, or other role; and investigative services that make use of the CPA's skills that may or may not lead to courtroom testimony. Forensic accounting may involve the application of special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance that has the potential to improve audit quality in detecting material financial misstatements, whether caused by fraud or error. SAS No 99 includes the suggestion that an "auditor may respond to an identified risk of material misstatement due to fraud by assigning...forensic...specialists."²

In addition, many of the suggested procedures in SAS No. 99 are forensic in nature. Such procedures involve the performance of substantive tests or the application of methods and techniques of evidence collection that presume the possibility of dishonesty at various levels of management, including override of internal controls, falsification of documents, and collusion. Examples include interviews of financial and non financial personnel in greater depth or breadth than is customarily the case, unannounced recounts of inventory items, tests of accounts not ordinarily performed, and tests of accounts traditionally or frequently deemed low risk, among many other procedures.

The FLS believes that additional guidance may be needed to assist the forensic accountant, audit committees, financial statement audit teams, and others who use the services of the forensic accountant. The goal of such guidance would be to enhance the validity, reliability, consistency, and transparency of such work and related results. Respondents' answers to the following questions are needed to proceed effectively. In addition, the FLS welcomes other questions, comments, and suggestions. Comments should be sent via the Internet to James Feldman at jfeldman@aicpa.org and received by October 15, 2004.

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DISCUSSION MEMORANDUM

FORENSIC SERVICES, AUDITS, AND CORPORATE GOVERNANCE: BRIDGING THE GAP

July 15, 2004

Prepared by the AICPA Forensic and Litigation Services Committee and Fraud Task Force
for comment from persons interested in forensic services issues

Comments should be sent via the Internet to James Feldman at jfeldman@aicpa.org and
received by October 15, 2004.

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JULY 15, 2004

To: Interested Parties
From: AICPA Forensic and Litigation Services Committee

The AICPA Forensic and Litigation Services Committee (FLS or FLS Committee) is soliciting information to assist in the development of guidance for CPAs providing forensic services. The guidance will focus on the area of forensic services involving CPAs, which is referred to in this paper as forensic accounting. Such guidance is expected to also be a useful resource for external auditors, internal auditors, corporate management and directors responsible for corporate governance, and other groups interested in the goal of improving financial reporting. The purpose of this discussion paper is to describe the specific questions for which the FLS would like to receive comments before guidance is developed. In addition, the paper includes the FLS's initial observations and views concerning forensic accountants' services, including involvement with the independent audit team to (1) increase financial statement audit effectiveness in applying AICPA Statement of Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and (2) execute accounting-related fraud investigations.

On September 22, 2004, the FLS will sponsor a roundtable. The AICPA will invite leaders working in financial and managerial accounting, auditing, and forensic accounting, as well as representatives from regulatory agencies and corporate governance associations. The AICPA will request that all speakers submit written comments on the discussion paper. Members of the general public are also invited to attend by registering in advance.

The FLS Committee welcomes comments on this discussion paper from all interested parties, and requests that comments be sent no later than October 15, 2004, to the following e-mail or postal address:

E-mail: jfeldman@aicpa.org

AICPA

Forensic and Litigation Services Committee

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Upon completion of the roundtable and consideration of comments received, the AICPA plans to develop guidance for forensic accounting practitioners and to identify ways for CPAs with experience in the forensic services discipline to work effectively with those CPAs who practice in the traditional attest discipline. The FLS Committee believes that such guidance will help to improve the integrity of financial reporting, consistent with the commitment of the CPA profession to protect the public interest.

Thank you in advance for your time and effort.

**AICPA Forensic and Litigation Services Committee
2002–2003 and 2003–2004**

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The AICPA Forensic and Litigation Services Committee extends special thanks to the members of its 2002–2004 Fraud Task Force, including Bert F. Lacativo, Ronald L. Durkin, Elliott Leary, Edward D. Martin, D. Larry Crumbley, Philip C. Levi, Debra A. Cutler, Philip A. Desing, and James Robert Trimbach. We are also grateful for the assistance of Charles E. Landes, AICPA Director Audit and Attest Standards, and Alan W. Anderson, AICPA Senior Vice President—Member and Public Interest.

FORENSIC SERVICES, AUDITS, AND CORPORATE GOVERNANCE:

BRIDGING THE GAP

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While many definitions exist for the general term *forensic*,¹ the AICPA's Forensic and Litigation Services Committee (FLS) believes that forensic accounting consists of two major components:

¹ According to the *Random House Webster's College Dictionary*, *forensic* is defined as pertaining to, connected with, or used in courts of law or public discussion and debate.

litigation services that recognize the role of the CPA as an expert, consultant, or other role; and investigative services that make use of the CPA's skills that may or may not lead to courtroom testimony. Forensic accounting may involve the application of special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

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In addition, many of the suggested procedures in SAS No. 99 are forensic in nature. Such procedures involve the performance of substantive tests or the application of methods and techniques of evidence collection that presume the possibility of dishonesty at various levels of management, including override of internal controls, falsification of documents, and collusion. Examples include interviews of financial and nonfinancial personnel in greater depth or breadth than is customarily the case, unannounced recounts of inventory items, tests of accounts not ordinarily performed, and tests of accounts traditionally or frequently deemed low risk, among many other procedures.

The FLS believes that additional guidance may be needed to assist the forensic accountant, audit committees, financial statement audit teams, and others who use the services of the forensic accountant. The goal of such guidance would be to enhance the validity, reliability, consistency, and transparency of such work and related results. Respondents' answers to the following questions are needed to proceed effectively. In addition, the FLS welcomes other questions, comments, and suggestions.

² Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316.50).

QUESTIONS FOR RESPONDENTS

1. Is the additional audit guidance provided in SAS No. 99 sufficient to improve the overall quality of the audit process to adequately protect the interests of investors and other audited financial statement users against fraudulent financial reporting? Or should the AICPA require forensic procedures that are more specific and more extensive than those currently described in SAS No. 99?
2. Would the quality of the audit process be enhanced and the interests of the public served more effectively by requiring forensic accountants to participate in the audit process? If so, to what extent?
3. If the answer to question 2 is yes, would you expect there to be a difference in how the forensic accountant is used in an audit of a public company versus an audit of nonpublic entity? If so, please explain.
4. Should the debate about questions 1 and 2 be limited to financial statement fraud and exclude consideration of misappropriation of assets?
5. How and to what extent should audit committees or internal auditors use the services of forensic accountants?
6. If auditors of a company provide forensic services (separate from the audit) to management or the audit committee, can these services impair the audit firm's independence? If yes, under what circumstances?
7. To protect the interests of the public, what education, training, and experience should a forensic accountant possess to participate either as a specialist or a member of the audit team? Should a forensic accountant be identified as such only when the individual has met certain required education and training curricula? Should meeting the required education, training, and experience result in certification?

8. If the AICPA expands the use of forensic procedures beyond what is currently required by SAS No. 99, will the resulting legal consequences of not detecting fraud put the audit profession at an unacceptable level of risk, especially when the fraud involves third parties?
9. Audit standards currently include consideration of cost benefit analysis in terms of audit procedures (SAS No. 31, *Evidential Matter* [AICPA, *Professional Standards*, vol. 1, AU sec. 326.23]). Should this concept be continued? If so, how would it affect answers to any of the above questions?

This discussion paper provides supporting background material to assist in consideration of these questions.

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I. INTRODUCTION

Purpose

The AICPA's Forensic and Litigation Services Committee developed this paper to explore the ways in which forensic accounting professionals can provide assistance to audit committees, financial statement audit teams, and other corporate governance groups interested in the goal of improving financial reporting. Questions addressed in this paper include the following:

- What is forensic accounting?
- What are the qualifications of a forensic accountant?
- What forensic procedures used by these practitioners could or should become a part of a financial statement audit?
- What authoritative guidance governs the work of these practitioners now and in the future?

While many definitions exist for the general term *forensic*, the FLS believes that forensic accounting consists of two major components: litigation services that recognize the role of the CPA as an expert, consultant, or other role; and investigative services that make use of the services of CPAs that may or may not lead to courtroom testimony.³ Such services may involve the application of special skills in accounting, auditing, finance, quantitative methods, certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.

The application of forensic procedures in investigations and in financial statement audits is explored in the context of procedures now employed by forensic accountants and financial statement auditors. For example, procedures in a financial statement audit may involve the performance of substantive tests or the application of methods and techniques of evidence collection that presume the possibility of dishonesty at various levels of management, including

³ See footnote 1 for a definition of *forensic*.

override of internal controls, falsification of documents, and collusion. These procedures are forensic in nature including, for example, interviews of financial and nonfinancial personnel in greater depth or breadth than is customarily the case, unannounced recounts of inventory items, tests of accounts not ordinarily performed, and tests of accounts traditionally or frequently deemed low risk, among many other procedures.

This discussion paper also explores the relationship of forensic accountants, external auditors, internal auditors, and others who have a role in complying with the provisions of Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

In an audit conducted in accordance with GAAS, auditors have the responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement—including any material misstatements caused by fraud or error. SAS No. 99 has not changed the external auditors' overall responsibilities, but it has the potential to improve the audit quality with respect to achieving this objective. An issue explored in this paper is whether the use of forensic accountants in the application of SAS No. 99 would further increase the potential of detecting material fraud.

Background

The public tends to perceive that an audit is designed to detect all forms of corporate fraud. The auditor conducting an audit in compliance with GAAS, however, is required to plan and perform the audit to obtain *reasonable assurance* that the financial statements are free of material misstatements—whether caused by error or fraud. The difference between the public's expectation of the purposes and objectives of an audit and the CPA's responsibilities under GAAS has been referred to as the "expectation gap."

In light of the major corporate frauds at Enron, WorldCom, and other companies—and the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) in response to these frauds—this

gap may have widened further. If external auditors complete an audit of a corporation in accordance with GAAS and do not detect fraud, but fraud is, nonetheless, subsequently uncovered, the general investing public is still likely to ask, “Where were the auditors?” An increased application of forensic procedures may assist the CPA profession to bridge the “expectation gap” with regulators, the courts, and the general public by increasing the likelihood of uncovering material fraud.

SAS No. 99 was four years in the making when it was issued in October 2002—under development before the events surrounding Enron and WorldCom came to light, and drafted before Sarbanes-Oxley. The AICPA’s Auditing Standards Board, in issuing SAS No. 99, considered several studies, the results of academic research on how auditors implemented previous standards on fraud, and the comments of many group and individual stakeholders in the financial reporting process.

SAS No. 99, effective for audits of financial statements for periods beginning on or after December 15, 2002, “establishes standards and provides guidance to auditors in fulfilling [their] responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with [GAAS].”⁴ The Statement includes a discussion of fraud and its characteristics, significant guidance on identifying the risk of fraud, and suggested approaches to responding to such risk. The risk identification process and response to such risk includes a discussion of procedures that are forensic in nature. SAS No. 99 provides limited guidance on the specific procedures that should be applied, however, if the auditor concludes that indicia of fraud are present.

II. THE ROLE OF THE FORENSIC ACCOUNTANT IN THE AUDIT

The forensic accountant can play a vital role in combining investigative procedures with traditional audit procedures in a financial statement audit. The skills involved in forensic accounting are different from those usually involved in financial statement audits. CPAs performing forensic accounting normally have special skills in accounting, auditing, quantitative methods, aspects of

⁴ SAS No. 99 (AU sec. 316.01).

law, research, and investigative techniques, and are trained to perform substantive tests and evidence collection procedures directed at the possibility of fraud. They have a different mindset from the traditional auditor's, as they do not ordinarily maintain a neutral stance characterized as "professional skepticism."

SAS No. 99 does not identify the specific skills or training necessary to effectively perform forensic accounting. While an exhibit to SAS No. 99 specifically refers to the Certified Fraud Examiner (CFE) credential offered by the Association of Certified Fraud Examiners (ACFE), and describes CFE holders as one component of an organizational oversight program, the Statement does not indicate or imply that CFE holders should be a part of the audit team. One reason for this is that although many CFE holders are CPAs, the CPA credential is not required to become a CFE.⁵

While SAS No. 99 states that persons with specialized forensic skills may be assigned to an audit engagement in response to an identified risk of material misstatement due to fraud, the Statement does not indicate what qualifications, education, and training would be appropriate or how such a person's role should be integrated into the audit engagement.⁶ The Statement also does not address the question of whether such a person should be considered a member of the audit team or participate as a specialist.

To address the issue of skills needed to perform forensic accounting, the AICPA has developed a Web-based Competency Self-Assessment Tool (CAT) that includes the *Fraud Prevention, Detection, and Investigation Model*. The model identifies skill sets for a variety of positions, such as specialist, independent auditor, internal auditor, and others. Although CAT was originally designed primarily as a means for personal development, it may also be useful for defining the required skill sets of the forensic accounting practitioner at basic, intermediate, and advanced

⁵ See SAS No. 99 Exhibit, the section "Certified Fraud Examiners," in the exhibit "Management Antifraud Programs and Control."

⁶ SAS No. 99 (AU sec. 316.50) states that "the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology (IT) specialists, or by assigning more experienced personnel to the engagement."

levels of performance.⁷

The auditing profession has many tools to help it bridge the expectation gap, including SAS No. 99, Sarbanes-Oxley, and the related rules promulgated by the Securities and Exchange Commission (SEC), the fraud triangle, and application of Richard Nossen's seven investigative techniques, among others.⁸ Depending on the audit, the audit environment, the audit risk factors, and other concerns, the auditor has to determine the most effective ways to employ forensic procedures or investigative techniques in connection with the audit.

The forensic accountant brings a variety of investigative techniques to the audit to assist in identifying audit risk factors and possible material misstatements due to fraud. The identification of fraud risk areas centers on conditions that are generally present in the "fraud triangle." SAS No. 99 discusses the fraud triangle as a means of laying a foundation for understanding financial statement fraud and misappropriation of assets.⁹ The fraud triangle consists of the following three conditions, which are generally present when fraud occurs:

1. *Incentive or pressure.* Management or other employees may have an incentive or pressure that becomes the motive to commit fraud.
2. *Opportunity.* Circumstances may exist at the entity that provide an opportunity for a fraud to be perpetrated.
3. *Rationalization or attitude.* Some individuals possess an attitude, character, or set of ethical values that allows them to rationalize committing a dishonest act.

The use of auditing procedures may identify the circumstances that create the pressures or incentive to commit fraud. An internal controls review may reveal that an entity's disclosure and

⁷ The AICPA's *Competency Assessment Tool* and the *Fraud Prevention, Detection, and Investigation Model* are available online at www.cpa2biz.com/CPEConferences.

⁸ *The Seventh Basic Investigative Technique- Analyzing Financial Transactions in the Investigation of Organized Crime and White Collar Targets*, by Richard A. Nossen, describes the following techniques: (1) public document reviews and background investigations (nonfinancial documentation), (2) interviews of knowledgeable persons, (3) confidential sources and informants, (4) laboratory analysis of physical and electronic evidence, (5) physical and electronic surveillance, (6) undercover operations, and (7) analysis of financial transactions.

⁹ SAS No. 99 (Appendix, "Examples of Fraud Risk Factors").

financial controls are strong, but senior management may be overriding these controls. Further, fraud by its nature usually involves concealment, and the perpetrator(s) may be colluding with others. A strong ethical tone at the top is one means to assess the organization under review, and auditors may be able to assess attitudes in the organization through observation and effective interviews.

Because auditing procedures are not designed to detect all forms of corporate fraud and illegal acts, and auditors are typically not trained as fraud investigators, forensic accountants bring important skills to the audit environment.

An effective forensic accountant, operating in an audit environment, needs to have a sufficient understanding of the industry as well as an understanding of accounting, auditing procedures, investigative techniques, evidence gathering, and the litigation process. Not all forensic accountants possess such knowledge and skills, but most—if not all—forensic accountants have a working knowledge of accounting, auditing, and the litigation process.

When SAS No. 99 was written, it was anticipated that auditors who perform an audit in accordance with GAAS would be capable of fulfilling the requirements of SAS No. 99 with the requisite professional skepticism. Situations where this seems most likely include the following: a low-risk environment exists where the integrity of management is unquestioned, strong antifraud programs and policies are in place, incentives and opportunities for fraud are minimal, and the results of analytical procedures and other audit evidence gathering methods do not give rise to significant fraud risk concerns.

Fulfilling the requirements of SAS No. 99 with the requisite professional skepticism, however, is likely to be more difficult in situations where the auditors' ability to rely on these factors deteriorates. When the existence of fraud becomes more likely through the discovery of indicia of fraud, for example, there may be an increasing expectation that an auditor perform more forensic procedures, as previously discussed.

Also, as auditors expand procedures directed at fraud detection, the identification of fraud risk factors and the demand for the forensic accountant's capabilities are likely to increase. The point at which a forensic accountant or other specialist is brought into the audit will vary on a case-by-case basis, but some forethought should be given to this decision. Various factors, such as the audit firm's level of forensic capabilities, need to be considered. Another consideration involves deciding whether to use in-house or outside forensic accountants on certain aspects of the audit.

If forensic expertise is brought in, a key variable that will need to be focused on is whether the forensic accountants will be acting as members of the audit team, or will be separately engaged by management or the audit committee. Another key variable is whether the forensic accountants are from the audit firm or (as discussed below) are brought in from outside. Sarbanes-Oxley places control of the audit of SEC registrants in the hands of the audit committees, and approval may be necessary to perform special, targeted forensic investigative procedures. The in-house expert who is retained as an adjunct to the audit team would play a key role in assisting in the identification of audit risk areas and developing appropriate tests and other procedures to respond to them. The audit team must consider how the forensic accountant performs his or her procedures, addressing such matters as the independence of the forensic accountant, scope of work to be performed, and communication of findings and analysis.

Hiring forensic accountants from outside the audit firm is also an option for a number of reasons. Some firms may lack in-house expertise. Other firms may conclude outside expertise is beneficial to avoid potential independence issues. Also, if the forensic accountants are hired through outside counsel, information may be protected by the attorney-client privilege and work product doctrine. Audit committee members may want an outside forensic accountant to complete an in-depth investigation in certain audit risk areas. The work of the audit committee, performed with the assistance of forensic accountants, may also provide comfort for the chief executive officer and chief financial officer, who are required to file certifications under Sarbanes-Oxley.

When there is an indication that fraudulent transactions or activities may have occurred, audit procedures expanded to include forensic techniques should be considered. If fraud indicators are

present, the audit team leader needs to determine the potential impact of such indicators on the financial statements.¹⁰ The impact of the alleged fraudulent transactions may be immaterial to the financial statements in terms of dollar amounts or disclosures but may still be significant if they indicate deception, misconduct, or breach of duties by management—warning signs of a poor tone at the top. And a poor tone at the top often represents indicia of other more significant fraudulent activity. Further, there is potential impact on the auditor’s opinion on the effectiveness of internal control over financial reporting for audits of public companies.

So what is to be done if there are indications that fraud may have occurred or a fraudulent scheme may be ongoing? The response varies, and there is no single correct answer for all circumstances. In some situations, conducting more substantive audit procedures is sufficient. In other situations, more specialized forensic techniques are necessary to uncover and determine the impact of the alleged fraud to the audit client and its financial statements. In any case, the auditing standards require the auditor to perform whatever procedures he or she considers necessary to obtain sufficient evidence to provide him or her with a reasonable basis for forming an opinion on the financial statements. Whatever procedures or techniques are used, the auditor or forensic accountant may need to consider conducting an in-depth investigation, separate from the audit of the financial statements, to determine the impact of the alleged fraudulent activities on the client and its financial statements.

If indicators of fraud are present that warrant further investigation, what should the outside auditor do if management is uncooperative, fails to provide information, or does not allow employees to be interviewed? SAS No. 99 and SEC rules provide guidance in this situation. SAS No. 99 addresses communicating possible fraud to management, the audit committee, and others, and

¹⁰ SAS No. 99 (AU sec. 316.52) states the following: “The *extent* of the procedures applied should reflect the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate (see SAS No. 39, *Audit Sampling* [AICPA, *Professional Standards*, vol. 1, AU sec. 350.23], and SAS No. 56). Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.” [Note: SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on performing analytical procedures as substantive tests.]

documenting the auditor's consideration of fraud.¹¹ Section 10A of the Securities and Exchange Act of 1934 requires an auditor to report directly to the SEC certain detected illegal acts.¹² The SEC issued Financial Reporting Release (FRR) No. 49, "Implementation of Section 10A of the Securities and Exchange Act of 1934," which alerts auditors and issuers to the possibility that the SEC may require in certain circumstances additional audit procedures, beyond those required by existing auditing standards.

Another situation that auditors need to be concerned about is the discovery of fraud that occurred in prior periods. As detection capabilities increase, the possibility of identifying fraud also increases. Frauds that have been ongoing for extended periods also are more likely to reach a higher level of materiality. These situations typically call for a separate fraud investigation to expose the full extent of the alleged fraud and to determine whether a restatement of prior period financial statements will be required.

Differences in Mindset: Audit and Forensic Accountant Materiality Thresholds

Materiality, in some cases, may not be as important to a forensic accountant as it would be to an auditor. A forensic accountant may focus more effort on a seemingly immaterial transaction than would an auditor. In the 1995 edition of *Fraud Auditing and Forensic Accounting: New Tools and Techniques*, Bologna and Lindquist state that small exceptions may provide significant insights.¹³ Minor differences, inconsistencies, oddities, and exceptions can be important to detect fraud. When engaged to assist the auditor, forensic accountants should look for indications of fraud that are often not subject to the scope of a financial statement audit.

Forensic accountants look for suspicious behavioral clues from management in conducting investigations. A lavish lifestyle could indicate that a manager or owner of a business is skimming

¹¹ SAS No. 99 (AU sec. 316.79-83).

¹² Consistent with GAAS, Section 10A of the Securities and Exchange Act of 1934 requires that, when an auditor becomes aware of information indicating that an illegal act (whether or not material to the financial statements) has occurred or may have occurred, the auditor would (1) determine whether it is likely that an illegal act has occurred, (2) evaluate the possible effect of the illegal act on the issuer's financial statements, and (3) promptly inform the appropriate level of the illegal act by management or otherwise. Section 10A specifies that the auditor notify the issuer's management and board of directors "as soon as practicable."

¹³ G. Jack Bologna and Robert L. Lindquist, *Fraud Auditing and Forensic Accounting: New Tools and Techniques* (New York: John Wiley & Sons, 1995).

money or diverting corporate assets and taking advantage of certain opportunities. Similarly, an employee who acquires luxury items that appear to be well beyond the employee's means may be an indication of fraud.

Forensic accountants are also alert to indications of a corporate "tone at the top" lacking in commitment to a strong value system founded on integrity. Based upon enforcement actions filed by the SEC between 1987 and 1999, of the 276 securities frauds that took place, the company's chief executive was involved about 70 percent of the time.¹⁴ Even when internal controls exist, top management can circumvent them. In the case of Adelphia Communications Corp., for example, one of the nation's largest cable companies at the time, prosecutors alleged that from 1999 to 2002, the company's founder and his two sons diverted billions of dollars from the corporation to themselves. The forensic accountant can play a critical role in implementing SAS No. 99 during the audit process and combating such frauds and thereby helping to prevent them from occurring in the future.

III. PROFESSIONAL STANDARDS AND NONAUTHORITATIVE GUIDANCE

SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), establishes a three-tier hierarchy of professional standards and other, nonauthoritative, guidance. The first tier consists of professional standards and is the most authoritative. The second tier consists of professional guidance having an established level of authority within the auditing profession. The third tier consists of nonauthoritative guidance, which does not establish standards but may provide preferred practices and helpful educational and reference material.

The AICPA Code of Professional Conduct requires all AICPA members to comply with standards applicable to the services performed. Therefore, the first tier for AICPA members performing an audit is the auditing standards. If forensic accountants are used as specialists who are not part of the audit team, the Statement on Standards for Consulting Services (SSCS) may apply to their work. Certain legal and regulatory requirements may also apply. For example, Sarbanes-Oxley

¹⁴ Ken Brown, "Auditor's Methods Make It Hard to Catch Fraud by Executives," *Wall Street Journal*, July 8, 2002, p. C-3.

prohibits CPA firms that audit publicly traded corporations from performing certain types of consulting services. CPAs are also subject to relevant standards established by state boards of accountancy or other licensing agencies and by other professional organizations to which the practitioner may belong.

The second tier within the hierarchy of professional standards, as set forth in SAS No. 95, is authoritative guidance issued by the AICPA and cleared by the Auditing Standards Board, including AICPA Interpretations of Auditing Standards, AICPA Audit and Accounting Guides, and AICPA Statements of Position.

The third tier comprises professional nonauthoritative guidance, such as general fieldwork and reporting manuals, and includes AICPA practice aids and special reports.

SSCS applies to consulting engagements where a CPA performs litigation services. All CPAs, whether auditors or forensic accountants who use various investigative and forensic procedures in an audit environment, are required to comply with Rule 201, *General Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 201.01), of the AICPA Code of Professional Conduct, which comprise the general standards that require (1) professional competence, (2) due professional care, (3) planning and supervision, and (4) sufficient relevant data.

Additionally, SSCS establishes the standards of client interest, understanding with client, and communication with the client. These understandings may be communicated through the audit partner, or they may be arranged separately with counsel, depending on the circumstances of the engagement. When forensic procedures are incorporated in an audit and forensic accountants perform them, some confusion may arise about which professional standards apply. For example, if during the audit of the financial statements, a fraud investigation is deemed necessary, will the audit firm's independence be impaired if the audit firm performs the investigation? If the fraud investigation is performed by forensic accountants employed by the audit firm, what professional standards should apply?

Chart 1 depicts the existing relationship between an audit and an investigation, and Chart 2 shows changes believed to be taking place or should take place today. If the environment is changing as depicted in Chart 2, what guidance should the forensic accountant follow?

Chart 1

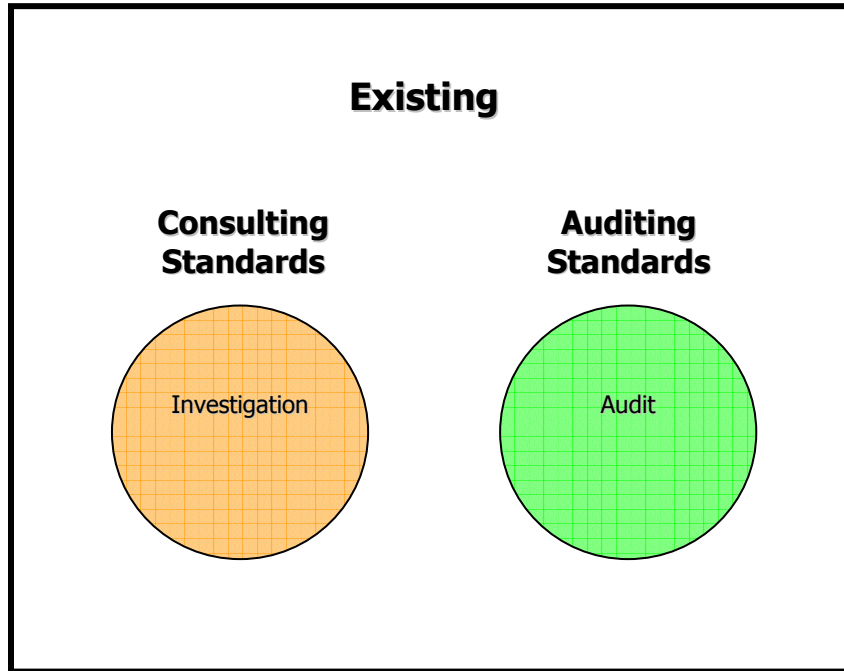
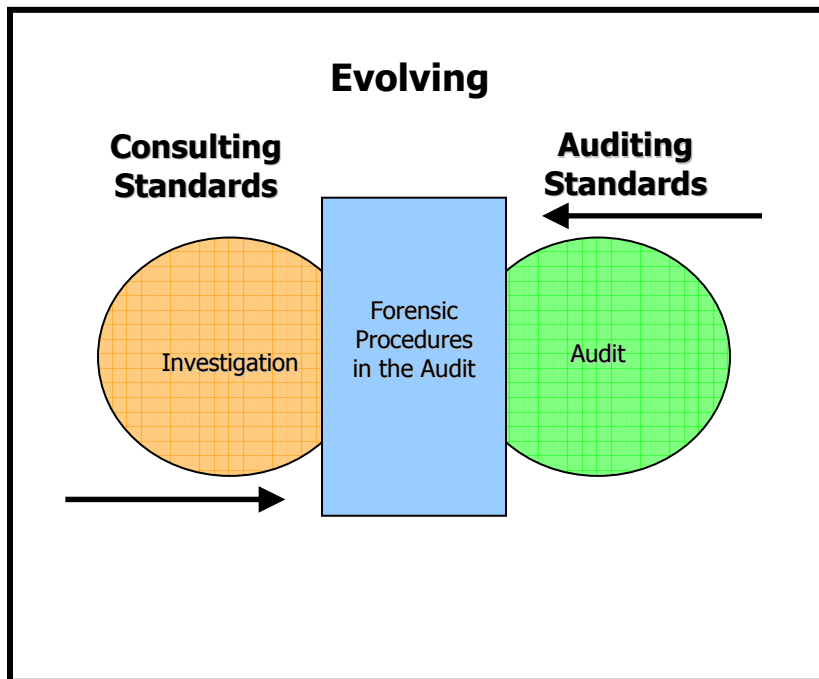


Chart 2



In determining which professional standards apply when a CPA employs forensic procedures, one must first determine whether the engagement is an audit, an adjunct to an audit, or a separate litigation services engagement.

Auditors conduct some procedures that are forensic or investigative in nature. For example, two procedures that may also be considered investigative techniques are performing analytical procedures and conducting inquiries of management and others (interviews). Assuming that an auditor's procedures reveal that indicia of fraud are present, the auditor's typical response may be to expand the scope of the audit to identify the existence and materiality of the potential fraud. These expanded procedures, if they include techniques normally employed by forensic accountants, may make this audit work resemble an investigation in many respects. Because auditors are typically not fraud investigators and an audit is not designed to detect all forms of corporate fraud, the standards that apply to these procedures may need to be clarified.

There also may be an issue of whether the auditor can conduct a comprehensive fraud investigation for an SEC registrant. The SEC stated in its final rule:

Auditors should conduct these procedures [investigation of material financial statement fraud] whether they become aware of a potential illegal act as a result of audit, review or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system. In these situations, we believe that the auditor may conduct the procedures, with the approval of the audit committee, and provide the reports that the auditor deems appropriate. Should litigation arise or an investigation commence during the time period that the auditors are conducting such procedures, we would not deem the completion of these procedures to be prohibited expert services so long as the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

If a forensic accountant has been included as a member of the audit team, he or she is expected to comply with applicable GAAS standards for the work performed. In practice are auditing standards being applied to these services? Are audit teams making the determination that such specialists are a member of the audit team?

On the other hand, the audit committee (or senior management of a nonpublic entity) may engage the services of a forensic accountant with a purpose other than the issuance of the auditors' report on the financial statements—an engagement in anticipation of litigation. Investigative techniques concerning alleged accounting and financial fraud are traditionally performed by forensic accountants and may be outside the scope of traditional audit procedures. Forensic accountants often contemplate litigation at some point either during their work or as a result of it. In accordance with AICPA Consulting Special Report 03-01, *Litigation Services and Applicable Professional Standards*, CPAs who perform litigation services are required to follow SSCS as well as the AICPA Code of Professional Conduct.

IV. SAS NO. 99, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

SAS No. 99 "...establishes standards and provides guidance to auditors in fulfilling that responsibility [to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement], as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards."¹⁵

Even with the guidance set forth by SAS No. 99, an audit can still be conducted in accordance with GAAS and not detect a material misstatement resulting from all forms of corporate fraud. Today, an audit still relies heavily on testing of balances and transactions and management's representations. The danger in this environment is that (1) management may intentionally deceive the auditor about material financial misstatements, (2) the inherent limitations of the audit tests fail to detect material misstatements due to fraud, or (3) both conditions may exist.

¹⁵ SAS No. 99 (AU sec. 316.01).

Although the auditor may be following GAAS, the inability to detect fraudulent or illegal transactions or activities may constitute an audit failure in the public's perception. To potentially minimize this situation, use of a qualified forensic accountant can be a valuable asset to the audit engagement team. While the forensic accountant cannot be a guarantor that any existing fraud will be detected, the specialist's experience in detecting and investigating fraud may help auditors (1) assess the risk of material misstatement due to fraud, (2) design audit procedures that respond to the assessed risk of fraud, and (3) determine when a separate fraud investigation may be necessary.

SAS No. 99 raises many questions, many of which have yet to be answered. For example, are today's auditors qualified to perform procedures that are more forensic in nature? Should recommended audit procedures include more specific and extensive forensic procedures? What will be the difference, if any, with respect to fraud detection when private companies are audited, in contrast to publicly traded companies? Is the guidance provided by SAS No. 99 sufficient, or is additional guidance necessary?

V. FRAUD DETECTION PROCEDURES USED IN AN AUDIT ENVIRONMENT

Auditors who have not been trained as forensic accountants are incorporating enhanced fraud detection procedures into their audits. Auditors need to determine whether to perform the fraud detection procedures themselves or to include forensic accountants as part of the engagement team.

In some situations, macroenvironmental factors, including economic, regulatory and political conditions, may increase audit failure risk within an industry. Increased competition and management's need to meet earnings expectations may also increase the audit failure risk. Litigation commenced or threatened against a company, whistleblower allegations, regulatory actions, and other "buzz" within the company may indicate that fraud is occurring. Also, issues that may have surfaced during prior audits may need to be revisited.

When the decision is made to include outside forensic accountants to assist the audit team, some or all of the aforementioned issues may be researched by the forensic accountants during an information-gathering process in which a background and public records investigation is conducted. These and other issues are discussed with the audit team during the brainstorming session.

When accounting firms incorporate the work of forensic accountants into their audits, professional skepticism during the audit process can be greatly enhanced and an “investigative mentality” is incorporated into the audit. An investigative mindset is different from professional skepticism in that the forensic accountant is likely to require more extensive corroboration. The forensic accountant may also perform or assist with certain relevant investigative techniques as a means of gathering evidential matter concerning potentially material financial statement inaccuracies. Some of the more effective fraud detection procedures that might be performed by the forensic accountant are described as follows.

1. *Public document reviews and background investigations.* During the information-gathering phase, a forensic accountant attempts to learn critical background information about the client as well as the business and economic environment. Additionally, the forensic accountant attempts to identify vendors, suppliers, competitors, and related parties, and determine whether there are any triggering events that may give rise to behavioral changes. An example of what may be found in conducting a background search is the discovery of insider trading activity and the incentives that may cause company management to manage earnings to meet stock analysts’ expectations, inflate stock values, or both.
2. *Analytical procedures.* Vertical, horizontal, and ratio approaches to financial statement analysis and budgetary and industry comparisons help identify significant trends and changes. Analysis of the financial statements may reveal either existing relationships that are not expected or the absence of relationships that are expected to exist—both of which could be helpful in identifying potential misstatements whether caused by fraud or error. The auditor or the forensic accountant may examine unusual or questionable entries at or near the end of

the quarter or at year end. Use of technology-based programs can be helpful to identify certain attributes.

3. *Brainstorming session.* Before conducting the brainstorming session, the auditor or the forensic accountant gathers relevant background information, working papers from prior audits, and other information for analysis. The engagement staff must gain an understanding of general and industry-specific red flags that would affect the company being audited. Armed with this information, the auditor or forensic accountant discusses these issues, looking for input, feedback, and direction, as applicable, from other members of the engagement team. The brainstorming session should include all members of the audit engagement team. The benefit of including the entire team is to sensitize members to the possibility that fraud may exist, and to help members exchange ideas about how and where they believe the entity's financial statements might be susceptible to material misstatements due to fraud. The engagement team should discuss specific audit procedures to perform regarding periods of insider purchases and sales. The audit team may decide to conduct more substantive testing before, during, and after significant insider-trading periods.
4. *Interviews of management and others.* The auditor or forensic accountant normally should obtain background as well as other pertinent information during the interview to identify fraud risk areas. Matters to explore include the "tone at the top," business ethics, management style, values and beliefs, management strategies, reward systems, performance feedback, management structure, systems and controls, internal communications, and other variables. Interviews should probe potential motives and opportunities to override internal controls. While questioning management regarding the potential for fraudulent activity within the company is important, interviewers need to be alert that responses may be misleading if management's integrity is in question. Inquiries of lower-level personnel in a company's accounting department may reveal critical information and knowledge of suspicious journal entries made during certain identified risk periods (for example, at quarter end or during insider trading periods).

An example of the differences in approach might be a case where a staff auditor previously reviewed purchase orders, invoices, shipping documents, and other basic documentation. The auditor verified that the customer name and sales amount were correct, and that the purchase order, sales, and shipping dates all appeared reasonable. The auditor then documented that the test work was completed without exception. What the forensic accountant added to the process was information from an e-mail notation, detected only through a careful and skeptical scouring of the vendor file. It read, "When the driver gets to the storage facility, it's not under XYZ Company, it's under John Doe." The forensic accountant discussed the situation with the senior on the job who said, "John Doe works here." Subsequently, many additional red flags were raised that ultimately led to the conclusion that XYZ Company was shipping its merchandise to its own storage facility and recording the shipments as sales.

This example is a pre-SAS No. 99 example. One would hope that a brainstorming session, along with a heightened sense of professional skepticism, would raise the issue that the shipping document provided an indication that goods were being shipped to an address different from the customer's address. However, a client who intentionally conceals information, colludes with others, and provides untruthful responses to auditor inquiries may ultimately succeed in deceiving an auditor. In this example, without searching for rental payments on the storage facility, closely examining the shipping documents, or asking appropriate questions, the client's explanation of events might have been accepted.

Another example where forensic techniques were successful occurred during an investigation at a company that initially believed that it had an embezzlement problem. Questioning of management, staff accountants, shipping clerks, and warehouse personnel, and a review of several layers of general ledger entries, revealed that an accounts payable clerk had initiated purchases of over \$1 million of compact disks in one year. She removed the expense from the income statement, put it on the balance sheet, and then tried to move it from there onto an off-balance sheet account. She then tried to cover her tracks by simultaneously making many unusual entries on the general ledger to balance the debits and credits. An examination of

invoices, interviews, and performance of other tests led to the discovery of the location of the \$1 million worth of compact disks in an off-site warehouse. The forensic accountant also found a series of money orders made payable to the accounts payable clerk from the supplier of the compact disks. Subsequent interviews and investigation revealed that the supplier was extorting the accounts payable clerk, forcing her to purchase large quantities of supplies or risk termination by her employer.

Of the various forensic procedures discussed, the analysis of financial transactions is probably the most useful. An analytical approach to risk assessment places the greatest emphasis on the skills possessed by forensic accountants. There are, however, numerous other procedures, which are sometimes overlooked in the course of an audit engagement. These procedures particularly come into play in investigative accounting assignments.

Some of the factors used in determining which procedure or investigative technique should be used depend on the evidence gathered, the indicia of fraudulent transactions present, and the nature of the allegations raised, if any. Practical considerations in determining what course of action to take include budget and time constraints as well as the capabilities of the auditors or their forensic accountants. For example, if data mining techniques are contemplated, the use of forensic technology specialists may be required to obtain appropriate audit evidence.¹⁶

VI. CONCLUSION

The demands of the investing public, U.S. corporations, and the regulatory environment have focused attention on the increased need to fight corporate fraud. The public is demanding greater vigilance from all parties involved in organizational governance. Audit committees are required to play a pivotal role in the prevention, detection, and deterrence of fraud, and to take appropriate action in the discovery of fraud. Independent public accountants and internal auditors also play an important part in the process. Forensic accountants have emerged, however, as vital newly

¹⁶ *Data mining* is an analytic process designed to explore large amounts of data to search for consistent patterns, systematic relationships, or both, between variables. Then, the findings are validated by applying the detected patterns to new subsets of data.

recognized allies in the fight against fraud, whether serving as members of the audit team or as consultants that are independent from the audit engagement. In these roles, forensic accountants may help to ensure compliance with SAS No. 99 as well as the Sarbanes-Oxley Act for audits of public companies.

The forensic accountant can play a key role in bridging the gap between an audit and an investigation. Every audit cannot, and should not, be conducted as a full-fledged forensic investigation. GAAS states, "An auditor typically works within economic limits; the auditor's opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost."¹⁷ Forensic investigations may also be subject to such constraints, but the parameters are often vastly different. As a result, a forensic investigation might represent a large multiple, in both cost and elapsed time, of what an audit would normally entail. This approach will undoubtedly reduce the likelihood of undetected fraud. However, such an approach might also reduce the likelihood of completing the engagement in time for meeting the filing deadline for an SEC Form 10-K, for example.

What is needed is an increased awareness on the part of both forensic accountants and attest auditors of when and how their respective skills can complement each other, and when and how it may be better to apply them separately. We believe the answers to the section "Questions for Respondents," and the resulting guidance, will help to meet this objective. Your input is welcomed.

¹⁷ SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.23).

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