

Lecture Notes on Forensic Accounting Investigations*

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1 Introduction

Fraud is a legal and not an accounting concept. For this reason, the accountants have traditionally chosen to treat it as a concept alien to them.

1.1 What is fraud?

There are four elements to any fraud:

- A false representation of a material nature (either misstatement or omission of a material fact)
- *Scienter*: Knowledge that the representation is false, or reckless disregard for truth
- *Reliance*: The person receiving the representation has reasonably and justifiably relied on it
- *Damages*: Such receiving party has sustained financial damages from all of the above

It is important to note that the under the securities laws, some of these conditions are relaxed.

1.2 Types of Fraud

- Misappropriation of assets (Retail Fraud)
- Financial Statement Fraud (Wholesale Fraud)

*These notes are based on the book *A Guide to Forensic Accounting Investigations* by Thomas W. Golden, Steven L. Skalak, and Mona M. Clayton. They are meant for the exclusive use of the students in the course Acc 551 at SUNY Albany

1.3 Gatekeepers

- Macro level
 - Standard setters
 - Market Regulators
 - Emerging Technologies
- Micro level
 - Board of directors
 - External Auditors
 - Analysts
 - Legal Profession

1.4 Fraud Deterrence Cycle

- Corporate Governance
- Transaction level control of processes (System of internal control)
- Audit of corporate governance and internal control
- Investigation/remediation of suspected alleged problems

1.5 Auditing History Timeline

- Pre-1929: GAAP determined primarily by common law
- 1929 stock market crash
- Securities Act 1933, Securities & Exchange Act 1934, and the establishment of the SEC
- Establishment of the Committee on Accounting Procedure (AICPA) 1939
- Accounting Principles Board (AICPA) 1959
- Trueblood Commission and subsequent establishment of the Financial Accounting Standards Board 1973
- Foreign Corrupt Practices Act 1977
- Sarbanes-Oxley Act 2002, Public Companies Accounting Oversight Board (PCAOB)

2 Auditor and the Forensic Accounting Investigator

The auditors' concerns include:

- Provide reasonable assurance that
- material misstatements do not exist and
- if they do exist, they are detected

Auditors generally concern themselves with deterrence only to the extent that lack of such deterrence can entail possibility of fraud. Auditors also are generally not concerned with investigations except in case of special engagements.

The Forensic Accounting Investigators' concerns, on the other hand, include:

- relatively narrow boundaries
- detailed development of factual information (from documentary as well as testimonial evidence)
- assessments of loss or damages based on the examination of the evidence
- recommendations to provide deterrence in the future

Forensic Accounting Investigator's findings and recommendations can be used in litigations as well as testimony before federal/state government and judicial agencies.

Both auditors and the forensic accounting investigators need to have:

- knowledge of the industry, the company and its business practices
- knowledge of GAAP in the jurisdiction
- skills in the interpretation of business documents and records
- independence and objectivity

Some observations:

- Generally, however, auditor/client relationships are not adversarial, but the relationship between the forensic accounting investigator and the client are adversarial
- Auditor is like a patrolman; a forensic accounting investigator is like a detective. Patrolman is always on patrol, a detective, however, is called on only when there is suspicion of fraud or fraud has already been detected