

Conducting Forensic Accounting and Internal Investigations

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Performing forensic analyses can be some of the most rewarding, but also the most challenging, work for a professional accountant. This discussion provides a practical guide to conducting forensic accounting and internal investigations. This discussion summarizes some of the real-world experiences of a seasoned forensic accountant.

INTRODUCTION

The term “forensic accounting” is often misused and misunderstood. When I tell someone that I am a forensic accountant, the response I typically get is, “So, like *CSI*¹ on television!” And then I say, “Yeah, sort of. But I investigate numbers instead of murders and dead bodies.” Then their excited facial expression fades away and they change the subject.

The practice of forensic accounting can be fascinating. In my 20-plus years of experience in the field, I have traced assets belonging to Holocaust victims, testified in litigation matters where the continuance of the company was at stake, worked as a special master,² investigated Ponzi schemes,³ managed teams involved in billion dollar litigations, analyzed large bank frauds, worked with the FBI and the Department of Justice in white-collar criminal matters, and testified in a televised murder trial.

The American Institute of Certified Public Accountants (“AICPA”) (the governing body of professional accountancy in the United States) defines forensic accounting as “the application of specialized knowledge and investigative skills possessed by CPAs to collect, analyze, and evaluate evidential matter, and to interpret and communicate findings in the courtroom, boardroom or other legal or administrative venue.”⁴

Professional accountants, mostly CPAs, conduct forensic accounting engagements. A subcategory

of forensic accounting is fraud examination. Fraud examinations may be conducted by either accountants or nonaccountants (collectively referred to as “analysts” throughout this discussion). When forensic accountants investigate allegations of misconduct or fraud within businesses, those investigations are often referred to as *internal investigations*.

This discussion provides summary information related to a variety of forensic accounting and internal investigation engagements.

Sometime earlier than 400 BC, Sophocles, the Greek tragedian, said that he would “rather fail with honor than succeed by fraud.” Unfortunately, in today’s time, that sentiment is becoming less common—especially in the corporate world.

A quick look at the business press over the past year produces numerous articles on financial statement frauds, corporate investigations, asset misappropriations, public corruption, and a host of other occupational frauds.⁵

In fact, the Association of Certified Fraud Examiners (“ACFE”) reported in its 2018 *Report to the Nations: Global Study on Occupational Fraud and Abuse*, that the total global fraud loss could be as high as \$4 trillion U.S. dollars (or roughly 5 percent of gross world product) per year.⁶ And these numbers do not appear to be decreasing even with the allocation of additional resources at the corporate level and the passing of 17 years since the Sarbanes-Oxley Act (“SOX”)⁷ became law.

This discussion makes no attempt to solve the problems of corporate fraud and abuse. Rather, this discussion addresses what to do once you discover an issue (or are retained to investigate an issue) from the perspective of the forensic analyst.

This discussion identifies the best practices for conducting forensic accounting investigations, including the following:

- Beginning the engagement
- Planning and communications during the engagement
- Executing the engagement
- Reporting findings

When executed properly, a forensic accounting investigation can accomplish several important tasks. It may assist triers of fact along with financial victims. It may also root out corruption in governmental and business organizations. And, finally, it may bring criminals to justice.

WHERE TO START

In most forensic engagements, an interested party wants an answer to two principal questions:

- What happened?
- Who is responsible?

And in many cases, the party looks to a forensic specialist to assist in answering those questions. In my experience, forensic accounting assignments generally begin in one of two ways.

First, there is an issue in litigation that requires analysis. Examples of these types of assignment include the following:

- Measurement of economic damages and lost profits
- Valuation of business interests, intellectual property, real estate, intangible assets, or other assets
- Transfer pricing
- Intellectual property infringement

Second, a governmental agency or business has a suspicion (or in some cases a confirmation) that some type of fraud has occurred in the organization. Forensic accountants or analysts are frequently retained to assist in the investigation of such frauds. In some instances, the analyst will be retained directly by the organization, while in other instances outside legal counsel retains the specialists.⁸

Examples of fraud examinations include the following:

- Corruption, including conflicts of interest, bribery, illegal gratuities, and economic extortion
- Asset misappropriation, including theft, fraudulent disbursements, inventory, and other assets
- Financial statement fraud⁹

According to the ACFE, fraud examinations can also address other organizational objectives, such as the following:¹⁰

- Identifying improper conduct
- Identifying the persons responsible for improper conduct
- Stopping fraud
- Sending a message throughout the organization that fraud will not be tolerated
- Determining the extent of political liabilities of losses that might exist
- Helping to facilitate the recovery of losses
- Stopping future losses
- Mitigating other potential consequences
- Strengthening internal control weaknesses

TYPES OF ENGAGEMENTS

There are infinite types of forensic accounting engagements. These assignments are primarily classified as:

1. accounting or nonaccounting,
2. litigation or nonlitigation, or
3. fraud or nonfraud.

While there is certainly overlap within the groups, the primary reason for the classification system is to make certain that the assembled professional team is both qualified and has the specialized knowledge to complete the assignment.

For example, if the assignment relates to financial statement fraud, the team is going to require accounting expertise. And because of the fraud component, the team will also require someone with experience interviewing financial personnel.

Finally, the analyst should assume that any assignment may end in litigation and, therefore, should consider whether he would make a credible witness in the case. If the answer to that question is no, the analyst should either reject the assignment or add someone to the team who would serve as a potential expert witness.

PROFESSIONAL STANDARDS

The analyst should also consider which (if any) professional standards may apply to the assignment. Credentialed accountants, valuation analysts, and fraud professionals may belong to different professional organizations with different sets of professional standards. CPAs should consider the following professional standards:

- AICPA *Code of Professional Conduct*
- AICPA *Statement on Standards of Consulting Services*
- AICPA *Statement on Standards for Attestation Services*
- AICPA *Statement on Standards for Forensic Services No. 1*¹¹

The valuation profession often follows the *Uniform Standards of Professional Appraisal Practice*, which includes both ethical and development/reporting standards for various valuation disciplines. Certified Fraud Examiners comply with the Association of Certified Fraud Examiners Code of Professional Ethics and Code of Professional Standards. It is the analyst's responsibility to know which standards apply to any assignment.

OTHER CONSIDERATIONS¹²

Prior to accepting any assignment, the analyst should make certain that he (or his firm) has no conflicts of interest. Generally, the analyst should examine the company, key executives, and any potential targets for conflicts.

The AICPA provides guidance on conflicts in the Forensic and Valuation Services Section Special Report 08-1: "Independence and Integrity and Objectivity in Performing Forensic and Valuation Services."

It is always a best practice to have an engagement letter with the client (preferably with the outside legal counsel representing the organization). It is also important, in general terms, to outline the nature and professional standards governing the assignment. If these issues are not addressed, the client may incorrectly assume that the forensic accountant is providing some type of assurance (such as an "audit" or a "review"). Unless such assurances are being provided, the analyst (even if a nonaccountant) should avoid using attestation terms like audit and review in engagement letters, working papers, and client correspondence.

The AICPA provides additional guidance on engagement letters in the Forensic and Valuation

Services Practice Aid 04-1: "Engagement Letters for Litigation Services."

As soon as practicable, the analyst should develop a scope of work for the assignment. At the beginning of the assignment, a high-level work plan should suffice. This plan may be expanded and refined as additional facts are discovered and analyses performed.

It is important to keep outside legal counsel apprised (assuming the client heeded your advice to hire outside counsel) of the progress of your work and informed of any changes in scope. This communication should help create a team environment and ease tensions when the invoices for your services arrive.

Finally, the analyst should not allow the client or outside counsel to control the scope of the assignment and at the same time request a report of "no findings." If you find yourself in this predicament, you should consider resigning from the assignment.

Taking the time to understand the appropriate professional standards, properly staff the assignment, investigate potential conflicts, prepare effective engagement letters, develop efficient work plans, and communicate with outside counsel will greatly increase the chances of conducting a successful forensic accounting assignment.

Practical Procedures

More often than not, one of the first questions out of the client's mouth is going to be, "How much is this going to cost?" And while estimating that number is very difficult in litigation settings, it is virtually impossible in fraud investigations. Why? A couple of reasons.

First, you do not know how deep the rabbit hole goes. What starts with an anonymous tip¹³ from one employee about another employee may turn into collusion with multiple employees. All of which will then need to be investigated. And collusion creates other more significant problems. It overrides internal controls, systems access, and ordinarily solid process and procedures.

Additionally, if the assignment is with a public company and the fraud involves an employee that the outside auditors relied upon in conducting the audit or internal control review, the independent auditors are likely going to be concerned about the reliability of their audit and wish to conduct some type of shadow investigation. Such an investigation is going to require periodic reporting, and additional time, from the forensic accountant.

I once investigated a large manufacturing conglomerate related to a financial statement fraud.

Ultimately, I determined that the CFO conspired with the division heads to falsify account records in order to maximize bonus pools. Collusion between senior employees makes fraud investigations difficult to solve and costly to complete.

Second, people are going to lie to you and that will slow you down. I led investigations where employees lied to cover up office affairs, where assistants lied to cover for their bosses, and controllers lied to cover for their business units. The most effective way to combat this lying is to analyze the evidence and the data and to effectively interview employees. This is because putting a piece of paper in front of someone that refutes their lie is the quickest way to get to the truth. Once the interviewee realizes you have done your due diligence, you will receive much more truthful answers.

Several years ago, I interviewed the corporate controller for a major division of a Fortune 500 company. The company received a whistle-blower complaint from their internal fraud hotline stating that the division was fraudulently overstating its operating results.

On the morning of day one of the investigation, the controller sat in the conference room with me, lined with the leather-bound volumes of internal controls and process and procedures documents required under SOX, and told me his books were perfectly clean and accurate.

On the afternoon of day three, after several interviews, the analysis of several hundred transactions, and a list of 30 or so written questions about certain end of the month journal entries, the same controller walked into the same conference room and confessed to the fraud. Because of his title and his longevity in the organization, he was able to override any of the existing internal controls. The SOX documents were worthless.

When I asked him why he was confessing, he confided to me that he knew once I started asking the right questions and not accepting his first answers, that I was going to eventually find the fraud—it was only a matter of how long it would take. And he said he could not sleep at night. Be consistent and skeptical and you will eventually find the answers.

Finally, electronic record keeping has made fraud investigations infinitely more complicated. Twenty years ago, analysts might look through the file cabinets located in an executive's office or the office of his secretary. Today, analysts have file servers, email systems, shared drives, text messages, and chat rooms.

And many businesses retain everything—forever! So, all of it should be analyzed for relevancy.

And even with computer tools, SQL databases, and structured data and computer analytics professionals doing the work, this analysis takes time and is expensive.

I once interviewed a woman who we believed was skimming money from her employer. She denied the allegations. I then reviewed her company emails along with her voice mail messages, text messages, and group chats from her company server. She obviously did not know that the company saved the metadata from the instant messages she sent through her work computer. Those messages not only showed how she was skimming the money, but also showed she was spending a good bit of it on her boss, with whom she was also having an affair. The company terminated both employees and referred the case to local law enforcement for prosecution.

My best recommendation to manage the client's expectations and engagement costs is to utilize a phased approach. I generally create an approach memorandum (or work plan) at the beginning of each forensic investigation. At a high level, the memorandum outlines the steps of the investigation and the estimated cost of each step. At the end of every week, I revise the memorandum, update the estimates, and circulate the updates to counsel and/or the client. This process keeps everyone on the same page and minimizes any "sticker shock" for your billings.

WHAT'S NEXT?

Preliminary Assessment

It is generally appropriate to conduct some type of preliminary assessment at the beginning of any forensics investigation. This assessment may include the following:

1. Gaining an understanding of internal controls and processes
2. Performing an analysis of records
3. Conducting some preliminary discussions with executives who are not a target¹⁴ of the investigation¹⁵

In many instances, the assessment requires the interaction of the forensic analyst with employees of the accounting and finance department of the company. Care should be taken during these interactions as the accounting and finance departments are often the targets of the investigation—and news travels fast even in very large organizations. In this type of environment, I will often introduce myself as a member of the independent audit team (with prior notification of counsel, of course).

The AICPA provides the following questions that may assist with the assessment:¹⁶

- What data are available? Understanding (1) the type of financial information that is available and (2) the related time periods covered will help the analyst assess the level of work and the cost required to gather and analyze the information.
- Are the data available in electronic format? Electronic data will make analysis more efficient and will provide for more comprehensible procedures. It is also helpful to request data that are in a proper format and compatible with any tools that the forensic accountant will use to perform an analysis. Including a specimen document request letter may facilitate the accurate collection of electronic data.
- Will the information be complete? Incomplete information will limit the practitioner's ability to produce accurate conclusions. The time spent to fill in incomplete data will also affect the cost of the investigation.
- Are there nonfinancial types of information that could help with the investigation? Other types of information, such as phone records, email, and building access logs could assist the forensic accountant with the assignment. It is important to inquire about what types of nonfinancial information are available.

Subsequent to the preliminary assessment, I will update the approach memorandum and consider any necessary changes to the team structure. Team changes are generally because of complex accounting issues, specific industry expertise requirements, and electronic data issues.

Working Papers

It is imperative that the analyst retain a complete set of working papers prepared during the investigation. That is not to say that all notes, schedules, and other documents should be retained. The analyst should determine whether notes or other materials are relevant to the investigation. If so, the notes should be formed into a memorandum or other document. If not, the materials should be discarded.

This is especially important for interview memorandums. The purpose of the interview memorandum is not to transcribe everything said during the interview, but rather to summarize the relevant



content. It is permissible to quote the interviewee for particularly important details.

In the event the analyst takes possession of original documents, it is important that the proper chain of custody be maintained to ensure preservation of the evidence.¹⁷ This is particularly important for documents with original signatures or items like cancelled checks, computer hard drives, and the like.

Communications

Communication should be directed to your client, be that outside legal counsel or company management. In some cases, the client may be the company's board of directors or audit committee. As noted above, it is always preferable for the client in forensic investigations to be legal counsel. That way if the analyst determines there is collusion or management involvement in the fraud, the analyst has an unbiased communication partner. If company management is the client, it is advisable to have management involve the board of directors or audit committee early in the assignment for the same reasons.

Finally, at some point in the investigation, the analyst and the client will need to determine how to communicate the conclusions from the assignment. This generally takes the form of a written report or an oral presentation. There are pros and cons to each method. Written reports take time and are expensive to write but provide high levels of detail.

Clients usually prefer written reports if they wish to refer the case to law enforcement or plan to seek reimbursement of costs from their insurance carrier. Oral reports can be prepared quickly, but only offer summary information. Clients generally prefer oral reports if they are concerned with legal privilege and discovery issues—if there is no report, no report can be produced. I have clients that requested oral presentations, but written reports for recommendations for internal controls as they wished to share the latter with their outside auditors.

Executing the Engagement

Subsequent to the approval of the work plans by the client, the analyst should begin executing the plan. While every forensic accounting assignment will vary, there are a couple of execution categories that should remain the same.

First, you will gather the relevant hard copy and electronic documents. In some cases, the hard copy documents may be voluminous. If so, the engagement team should either keep the copies of the documents off site or work with the client to obtain means to limit access to employees. Electronic documents (emails, spreadsheets, shared drives, etc.) are generally processed and loaded into a review environment tool. The processing of documents is complex and outside the scope of this discussion.

Second, depending on the type of assignment, the next step may involve the use of analytical procedures. These procedures may identify trends or unusual transactions that would assist the analyst. Some examples of analytical procedures include the following:¹⁸

- Comparison of company financial data versus operational data, such as production levels, number of employees, and square footage
- Comparison of current company data versus historical periods
- Comparison of actual financial results versus company budgets, forecasts, or projections
- Comparison of company data versus industry and competitor data
- Comparison of financial statement information with income tax returns
- Comparison of financial statements submitted to different parties or regulators
- Comparison of subsets of company data versus other subsets of company data (i.e., comparison of data on a disaggregated basis such as by division, product, location, or employee)
- Analyses of financial data in the context of external events (i.e., economic, political, etc.) or circumstances
- Vertical, horizontal, financial statement, and financial ratio analyses

Third, the analyst should begin scheduling interviews as quickly as practicable. Prior to any interview, the analyst should consider the following issues:

- Will outside legal counsel (for the company) attend the interview? If so, will they provide *Upjohn*¹⁹ warnings, background of the investigation, and or other privilege instructions? If not, will the analyst perform this task?
- The order of the interviews. Generally, you should interview the whistle-blower first (if applicable) and the subject of the investigation last. It is also a best practice to interview lower-level employees first. This should provide a solid base of knowledge for the interview of senior personnel.
- Site of the interviews. If you are interviewing an internal whistle-blower, it is better to conduct the interview at an off-site location. If on site, you will need a quiet and private location to conduct interviews so that the interviewee will feel comfortable.
- What if the interviewee requests legal counsel? Generally, this means an immediate halt to the interview until such time that interviewee can discuss options with his or her counsel.

Generally, the interviewer should have one additional person in attendance to take notes during the interview. I find it best to place the person taking notes slightly out of the direct eyesight of the interviewee. This keeps the interviewee's focus on the interviewer and not the notes that are being taken.

Interview memorandums should be prepared as quickly as possible after the interviews. This keeps the details of the interview fresh in your mind and significantly improves the quality of the memorandums. I have on occasion been asked by an interviewee for a copy of the interview memorandum. I have always refused this request on the basis the document is legally privileged and a work product of the investigation.

Practical Procedures

Conducting interviews is, by far, the most fun part of forensic investigations. But to be fun, the interview must be successful and the only way to a successful interview is through preparation. You need to walk into the interview knowing more than the interviewee thinks you know. Do your homework and prepare an outline. But perhaps more importantly, listen to what the interviewee is telling you.

I have seen interviews where the interviewer was so intent on his next question that he did not hear the response to the previous question. Be flexible enough to deviate from your outline when

the interviewee takes you in a fruitful direction, but return if you are not getting anywhere.

If you feel like the interviewee is not being truthful, ask the question again and again but in slightly different ways. Return to topics and see if you get slightly different responses. Many times your persistence will pay off and you will get to the truth. And your last question should always be, “Is there anything else you would like to tell me?” You may be surprised at some of the responses you get.

I once interviewed a woman who was the office manager of a large construction company. An internal whistle-blower alleged that several construction executives at the company were paying political contributions to select local politicians and then receiving reimbursements for those payments from company funds. The reimbursements were alleged to have been categorized as travel and other expenses in the company’s accounting system.

When I interviewed the whistle-blower, she told me that the office manager knew “everything that happened in this company” and that she was “close friends” with the executives in question. So, I spent several days going through the expense reports and pulled every expense for the past three years categorized as “travel” or “other” and without supporting documentation.

I then scheduled the interview with the office manager. I explained to her why I was there and outlined the whistle-blower’s allegations. She denied any knowledge of the allegations. I spent the next several hours going through the expense reports—I would cover 10 and then ask, “Do you know anything about these.” She would deny knowledge. I would cover 10 more then add, “Someone from an earlier interview said you were knowledgeable about this process.” She would deny knowledge.

At some point, she stopped me and said, “How long are we going to be here?” and I responded, “Until we find the truth.” After several more examples, she paused and explained how the fraud worked. She did not participate, but knew the details. She was tired of answering questions and just wanted someone to know that she was not responsible for the fraud. In this case, persistence paid off.

Finally, the analyst may perform additional substantive procedures as necessary. These procedures may include things like observations of internal control systems, asset tracing, analysis of access logs, examination of metadata from electronic media, selection of journal entries from the general ledger, and analysis of unusual or related party transactions. It is wise to seek consensus with the client



before undertaking these procedures (especially if the procedures were not part of your original work plan).

Reporting Findings

Documenting your findings is important and may be done in a variety of ways—both written and oral reports directly to the client are common. Additionally, the analyst may be asked to submit a report to a court or a law enforcement agency. Any investigative report should contain the following basic elements:²⁰

- Identify the client
- Include the analyst’s qualifications and background
- Describe the predication²¹
- State in broad terms what the analyst was asked to do
- Describe the engagement scope, including the time period examined
- Include mention of any restriction as to distribution and use of the report
- Identify the professional standards under which the work was conducted
- Identify exclusions in the reliance on the analyst’s report
- State that the work should not be relied on to detect fraud
- Include a list of the documents reviewed and relied upon during the investigation
- Include the names, titles/organizations, and dates of interviewees
- Include the procedures performed and the technical pronouncements relied upon
- Describe the observations and identify the findings

Finally, the analyst should not state definitive conclusions of fraud. You may conclude there were indications of fraud and you may even state that the subject of the investigation confessed to certain allegations, but the act of fraud is a legal conclusion and should be reserved for courts, judges, arbitrators, and juries.

SUMMARY AND CONCLUSION

Taking the time to properly plan and organize a forensic investigation will produce more efficient investigations and cost savings to your clients. This process involves communicating initial cost estimates, changes in scope, and tentative findings with the client.

Other issues, especially the pros and cons of the various types of reports, should be discussed early in the engagement. If the client either intends to seek reimbursement for the costs of the fraud and investigation for its insurance carrier or wishes to refer the matter to a law enforcement agency for prosecution, the analyst should prepare a written report. If these issues are not important to the client, but there are concerns about confidentiality or legal privilege, an oral presentation may suffice.

Finally, the success to the investigation very well may depend on the forensic interviews. Analysts should thoroughly prepare for the interviews and walk in knowing more than the interviewee expects. Clients should expect that the analyst has experience with effective interview techniques and can handle deceptive or confrontational interviewees.

Notes:

1. *CSI: Crime Scene Investigation* is a procedural forensics crime drama television series which ran on CBS from October 2000 through September 2015.
2. A special master is appointed by a court to carry out some sort of action on its behalf. Found at https://www.law.cornell.edu/wex/special_master.
3. A Ponzi scheme is a fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for early investors by acquiring new investors. Found at <https://www.investopedia.com/terms/p/ponzischeme.asp>.
4. AICPA Practice Aid 10-1, "Serving as an Expert Witness or Consultant."
5. The Association of Certified Fraud Examiners defines occupational fraud as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.
6. ACFE *Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse*, 8. The report may be downloaded for free at <https://www.acfe.com/report-to-the-nations/2018/>.

7. SOX required corporate executives to certify the financial statements under penalty of prosecution. Additionally, companies were required to publish details of their internal accounting controls. The thought at the time was that these processes would significantly decrease corporate fraud events. As of this writing, the success of SOX is debatable.
8. I always recommend the retention of outside legal counsel in fraud examinations and that outside legal counsel retain the specialist. This arrangement allows for confidentiality and legal privilege of the investigation until such time the company wishes to disclose any findings to governmental or other regulatory agencies.
9. ACFE *Report to the Nations*, 11. Summarized from Occupational Fraud and Abuse Classification System (the Fraud Tree).
10. ACFE *2016 Fraud Examiners Manual*, 3.101.
11. In June 2019, the AICPA issued SSFS 1, which provides authoritative guidance for AICPA members providing litigation and investigative services. The statement defines litigation and investigation for accounting purposes, outlines key considerations for client and provider relationships, and establishes boundaries on the services members can provide. The new standards take effect for new engagements accepted on or after January 1, 2020. Early adoption is permitted.
12. Summarized from AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation."
13. According to the ACFE 2014 *Report to the Nations*, more than 40 percent of all internal investigations originate with a tip from an employee, customer, or vendor.
14. Keep in mind potential collusion issues as discussed above.
15. AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation," 6.
16. *Ibid.*
17. *Ibid.*, 7.
18. *Ibid.*, 13.
19. Informally known as a corporate *Miranda* warning. Notifies an employee being interviewed that the legal counsel for the investigation represents the company and NOT the employee.
20. AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation," 17.
21. "Predication" is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred, is occurring, and/or will occur. ACFE *2016 Fraud Examiners Manual*, 3.105.

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