PacificCPE

COURSE
11501B

Foundations of Forensic Accounting and Fraud Examination

Build a strong foundation in forensic accounting with this introductory course covering the core concepts and frameworks that define the field. You'll explore how forensic accounting differs from traditional accounting practice, what fraud examination actually involves, and how professionals approach cases with a skeptical, investigative mindset. Real-world fraud scenarios and critical thinking exercises help bring the material to life. Whether you're new to the discipline or looking to strengthen your fundamentals, this course gives you the grounding needed to tackle more advanced fraud-related work with confidence.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the three categories of organizational fraud that make up the occupational fraud and abuse classification system (fraud tree).

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Chapter 1: CORE FOUNDATION RELATED TO FORENSIC ACCOUNTING AND FRAUD EXAMINATION

Chapter Objective

After completing this chapter, you should be able to:

- Recall the three categories of organizational fraud that make up the occupational fraud and abuse classification system (fraud tree).

Fraud News

In January 2022, according to *The New York Times*, Elizabeth Holmes, the founder of the failed blood testing start-up Theranos, was found guilty of four of 11 charges of fraud. Each sentence carries a maximum sentence of 20 years in prison (see "Elizabeth Holmes is found guilty of four counts of fraud," January 3, 2022).

Forensic accounting is simply defined as the intersection of accounting and the law. Consider an insurance claim whereby the insured is claiming that a contractor provided inferior work in March 2017 by placing an exposed water pipe in an unheated attic. In the first week of February 2018, during a two-day cold spell when temperatures dropped below freezing, the water pipe burst causing hundreds of thousands of dollars of water damage throughout 70% (4,200 of 6,000 square feet) of the building. Some questions to ponder include:

- Is the contractor liable for the water pipe failure 11 months later?
- What if there was a three-day cold spell in January 2018 and the pipe did not break? Would the contractor still be liable for the cost of damages from a water pipe break in February 2018?
- What if the water damage occurred at a retail establishment that needed to be closed for three months to repair the damage? Further consider that the business is located in "spring break territory" and earns 50% of its annual income (profit) during February, March, and April?
- Should the damages include lost profits?
- Is the extent of the damage (70% of the total square footage) relevant?
- Was there a contract between the contractor and the claimant?
- What parts of the contract might be relevant?

- Was there a warranty, implied or in writing (contractual)?

There are two overarching questions: (1) Is the contractor liable, and (2) If so, for how much? Further, notice that the calculation of damages involves not only dollars but also contractual obligations, down time, and peak dates, as well as the extent of damage (i.e., relevant nonfinancial issues).

Forensic accounting also considers employment damages arising from unfortunate events such as a work injury, an auto accident where the victim is unable to work, partially disabled, or has died as a result of the accident. Assume that a victim is rear-ended in an auto accident by an insured. Little doubt exists about the liability of the person, who caused the accident, and his insurance company. In such a case, forensic accounting professionals use a variety of financial information—such as W-2s and tax returns— along with relevant nonfinancial data, such as expected future number of years in the workforce and life expectancy—to place a value on the damages to the victim.

As noted in the previous two examples, forensic accounting issues can be complex and require more than basic accounting data.

Now consider the following case.

David Williams, 54, from Fort Worth, Texas, was arrested on October 12, 2017, by FBI special agents on a federal charge of engaging in a scheme to defraud insurance companies by submitting more than $25 million in false and fraudulent claims for medical services.[1]

> *According to the criminal complaint affidavit between November 2012 through August 2017, Williams advertised on his website (getfitwithdave.com) that he offered in-home fitness training and therapy through his company, "Kinesiology Specialists." Williams identified himself as "Dr. Dave" and stated that he served clients in most of Texas, Las Vegas, Denver, Tucson, Seattle, and Orlando. Through his website, Williams told potential clients that he was accepting most health care insurance coverage plans.*
>
> *In order to bill insurance companies for his services, Williams registered as a health care provider with the Centers for Medicare and Medicaid Services. In completing the application, Williams falsely certified that he was a health care provider. Williams enrolled as a health care provider at least nineteen times under different names or variations of his name and his company names, and falsely certified that he was a health care provider in each application. Williams would then bill the insurance companies as if he were a medical physician and as if he had provided care requiring medical decision-making of high complexity when Williams actually provided fitness and exercise training to his clients.*
>
> *According to the criminal complaint affidavit, Williams recruited potential clients through the use of flyers, the Internet, and word-of-mouth. Once recruited, Williams would typically meet with, or speak to, the new client over the phone and review their health history and goals for their planned*

fitness training. Williams would then typically assign a personal trainer to that individual. The personal trainer typically met with the client between one and three times a week for approximately one hour and provided fitness

training. Williams would then bill insurance companies for each training session using inaccurate codes and on certain occasions, billed for services that neither he, nor his staff, ever provided.

Between November 2012 through August 2017, Williams was paid in excess of $3.9 million in connection with his fraudulent billing of United HealthCare Services, Inc., Aetna, Inc., and Cigna.

We'll examine these topics across several modules. Those modules, along with the learning objectives, include the following:

- Module 1 examines fraud, its legal elements, major categories, common fraud schemes, and introduces the concept of abuse. The objective is for readers to be able to describe occupational fraud and abuse and to appreciate the complexities of pursuing legal action against fraudsters.
- Module 2 defines forensic accounting and contrasts forensic accounting engagements to fraud examinations. The goal in this module is for readers to be able to articulate the role of forensic accountants.
- Module 3 takes a look at some of the skills necessary to be a forensic accountant or fraud examiner. The goal is for readers to be able to identify the portfolio of required professional skills and to determine the alignment of their personal characteristics.
- Module 4 compares and contrasts auditing with fraud examination and forensic accounting. While understanding the similarities and differences between auditing, fraud examination, and forensic accounting take time, the take-away from module 4 will be the reader's ability to describe the role of each field and identify the similarities, differences, overlaps, and unique space of each.
- Module 5 offers an overview of the basics of fraud. Topics include the societal costs of fraud and litigation, as well as key metrics and fraud statistics from the Association of Certified Fraud Examiners' Report to the Nations, a biannual survey of fraud cases. The goal is for readers to recognize the cost of fraud and to develop profiles of fraud schemes, perpetrators, victims, and other relevant fraud-related attributes.
- Module 6 takes an initial look into the examination (investigation) of forensic accounting and fraud issues. The goal is to launch readers on a path toward the detection, investigation, and remediation of forensic accounting issues and fraud red flags.
- Module 7 provides an overview of the key elements of fraud examination. Fraud examination is more than just investigation of allegations, it also includes prevention, deterrence, detection, and remediation. Readers will be able to describe predication and articulate the activities associated with fraud examination.

MODULE 1: WHAT IS FRAUD?

Imagine that you work in the accounts payable department of your company, and you discover that your boss is padding his reimbursable travel expenses with personal expenses. Consider this: Walmart legend, Thomas Coughlin, who was described as a protégé and old hunting buddy of the company's late founder, Sam Walton, was forced to resign on March 25, 2005, from Walmart's Board of Directors. Mr. Coughlin, fifty-five years old at the time, periodically had subordinates create fake invoices to get the company to pay for his personal expenses. The questionable activity appeared to involve dozens of transactions over more than five years, including hunting vacations, custom-made alligator boots, and an expensive dog pen for his family home. Walmart indicated that it found questionable transactions totaling between $100,000 and $500,000. In his last year, Mr. Coughlin's compensation totaled more than $6 million. Interestingly, Mr. Coughlin was an outspoken critic of corporate chicanery. In 2002, he told the *Cleveland Plain Dealer*, "Anyone who is taking money from associates and shareholders ought to be shot."[2]

Answer these questions:

1. What would you do?
2. Should you report it to anyone?
3. Who could you trust?
4. Is this fraud?
5. If you don't report it, are you complicit in fraud?

Fraud, sometimes referred to as the fraudulent act, is an intentional deception, whether by omission or co-mission, that causes its victim to suffer an economic loss and/or the perpetrator to realize a gain. A simple working definition of fraud is "theft by deception."

Legal Elements of Fraud

Under common law, fraud includes four essential elements:

1. A material false statement
2. Knowledge that the statement was false when it was spoken
3. Reliance on the false statement by the victim
4. Damages resulting from the victim's reliance on the false statement

In the broadest sense, fraud can encompass any crime for gain that uses deception as its principal technique. This deception is implemented through fraud schemes: specific methodologies used to commit and conceal the fraudulent act. There are three ways to relieve a victim of money illegally: by force, trickery, or larceny. Those offenses that employ trickery are frauds.

The legal definition of fraud is the same whether the offense is criminal or civil; the difference is that criminal cases must meet a higher burden of proof. For example, let's assume an employee who worked in the warehouse of a computer manufacturer stole valuable computer chips when no one was looking and resold them to a competitor. This conduct is certainly illegal, but what law has the employee broken? Has he committed fraud? The answer, of course, is that it depends. Let us briefly review the legal ramifications of the theft.

The legal term for stealing is larceny, which is defined as "felonious stealing, taking and carrying, leading, riding, or driving away with another's personal property, with the intent to convert it or to deprive the owner thereof."[3] To prove that a person has committed larceny, we would need to prove the following four elements:

1. There was a taking or carrying away
2. of the money or property of another
3. without the consent of the owner and
4. with the intent to deprive the owner of its use or possession.

In our example, the employee definitely carried away his employer's property, and we can safely assume that this was done without the employer's consent. Furthermore, by taking the computer chips from the warehouse and selling them to a third party, the employee clearly demonstrated intent to deprive his employer of the ability to possess and use those chips. Therefore, the employee has committed larceny.

The employee might also be accused of having committed a tort known as conversion.[4] Conversion, in the legal sense, is "an unauthorized assumption and exercise of the right of ownership over goods or personal chattels belonging to another, to the alteration of their condition or the exclusion of the owner's rights."[5] A person commits a conversion when he or she takes possession of property that does not belong to him or her and, thereby, deprives the true owner of the property for any length of time. The employee in our example took possession of the computer chips when he stole them, and, by selling them, he has deprived his employer of that property. Therefore, the employee has also engaged in conversion of the company's property.

Furthermore, the act of stealing the computer chips also makes the employee an embezzler. "To embezzle means *willfully* to take, or convert to one's own use, another's money or property of which the wrongdoer acquired possession lawfully, by reason of some office or employment or position of trust." The key words in that definition are "acquired possession lawfully." For an embezzlement to occur, the person who stole the property must have been entitled to possession of the property at the time of the theft. Remember, possession is not the same as ownership. In our example, the employee might be entitled to possess the company's computer chips (to assemble them, pack them, store them, etc.), but clearly the chips belong to the employer, not the employee. When the employee steals the chips, he has committed embezzlement.

We might also observe that some employees have a recognized fiduciary relationship with their employers under the law. The term *fiduciary*, according to *Black's Law Dictionary*, means "a person holding a character analogous to a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person is said to act in a 'fiduciary capacity' when the business which he transacts, or the money or property which he handles, is not for his own benefit, but for another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part." In short, a fiduciary is someone who acts for the benefit of another.

Fiduciaries have a duty to act in the best interests of the person whom they represent. When they violate this duty, they can be liable under the tort of breach of fiduciary duty. The elements of this cause of action vary among jurisdictions, but in general, they consist of the following:

1. A fiduciary relationship existed between the plaintiff and the defendant
2. The defendant (fiduciary) breached his or her duty to the plaintiff
3. The breach resulted in either harm to the plaintiff or benefit to the fiduciary

A fiduciary duty is a very high standard of conduct that is not lightly imposed. The duty depends upon the existence of a fiduciary relationship between the two parties. In an employment scenario, a fiduciary relationship is usually found to exist only when the employee is "highly trusted" and enjoys a confidential or special relationship with the employer. Practically speaking, the law generally recognizes a fiduciary duty only for officers and directors of a company, not for ordinary employees. (In some cases, a quasi- fiduciary duty may exist for employees who are in possession of trade secrets; they have a duty not to disclose that confidential information.) The upshot is that the employee in our example most likely would not owe a fiduciary duty to his employer, and therefore he would not be liable for breach of fiduciary duty. However, if the example were changed so that an officer of the company stole a trade secret, that tort might apply.

But what about fraud? Recall that fraud always involves some form of deceit. If the employee in question simply walked out of the warehouse with a box of computer chips under his or her coat, this would not be fraud, because there is no deceit involved. (Although many would consider this a deceitful act, what we're really talking about when we say deceit, as reflected in the elements of the offense, is some sort of material false statement that the victim relies upon.)

Suppose, however, that before he put the box of computer chips under his coat and walked out of the warehouse, the employee tried to cover his trail by falsifying the company's inventory records. Now the character of the crime has changed. Those records are a statement of the company's inventory levels, and the employee has knowingly falsified them. The records are certainly material, because they are used to track the amount of inventory in the warehouse, and the company relies on them to determine how much inventory it has on hand, when it needs to order new inventory, etc.

Furthermore, the company has suffered harm as a result of the falsehood, because it now has an inventory shortage of which it is unaware.

Thus, all four attributes of fraud have now been satisfied: the employee has made a material false statement, the employee had knowledge that the statement was false, the company relied upon the statement, and the company has suffered damages. As a matter of law, the employee in question could be charged with a wide range of criminal and civil conduct: fraud, larceny, embezzlement, or conversion. As a practical matter, he or she will probably only be charged with larceny. The point, however, is that occupational fraud always involves deceit, and acts that look like other forms of misconduct, such as larceny, may indeed involve some sort of fraud. Throughout this course, we study not only schemes that have been labeled fraud by courts and legislatures but any acts of deceit by employees that fit our broader definition of occupational fraud and abuse. As you see later in Chapter 1, our recommended investigative approach does not require that you identify the specific law that was violated. Rather, the goal is to examine the relevant evidence with an eye toward demonstrating three attributes of the fraud:

- The scheme or fraud act
- The concealment activity
- The conversion or benefit

This approach ensures a careful and thorough examination of the issue without causing the forensic accountant to make decisions better suited to an attorney's expertise. We'll also use a thorough and careful examination of evidence associated with forensic accounting issues; again, this approach permits legal professionals to make determinations of which specific laws are relevant to the case facts and circumstances.

Major Categories of Fraud

Asset misappropriations involve the theft or misuse of an organization's assets. (Common examples include skimming cash and checks, stealing inventory, and payroll fraud.)

Corruption entails the unlawful or wrongful misuse of influence in a business transaction to procure personal benefit, contrary to an individual's duty to his or her employer or the rights of another. (Common examples include accepting kickbacks and engaging in conflicts of interest.)

Financial statement fraud and other fraudulent statements involve the intentional misrepresentation of financial or nonfinancial information to mislead others who are relying on it to make economic decisions. (Common examples include overstating revenues, understating liabilities or expenses, or making false promises regarding the safety and prospects of an *investment*.)

Enron founder Ken Lay and former chief executive officer (CEO) Jeff Skilling were convicted in May 2006 for their respective roles in the energy company's collapse in 2001. The guilty verdict against