PacificCPE

COURSE
11503B

Legal and Regulatory Environment of Fraud Examination

Fraud-related work doesn't happen in a vacuum — it takes place within a complex web of legal requirements, regulatory oversight, and professional standards. This course walks through the key laws and regulations that govern forensic accounting and fraud examination, along with the professional responsibilities practitioners must keep in mind when fraud is suspected or under investigation. You'll come away with a clearer understanding of the boundaries, obligations, and expectations that apply — essential knowledge for any CPA or tax professional operating in this space.

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

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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

- Identify the characteristics of the civil and criminal justice systems.

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Chapter 1: LEGAL, REGULATORY, AND PROFESSIONAL ENVIRONMENT

Chapter Objective

After completing this chapter, you should be able to:

- Identify the characteristics of the civil and criminal justice systems.

A Career Begins! By Jonathan Marks

At a young age, I learned a few things about myself. One, I am good at noticing things out of the ordinary. Two, I am able to remember with great detail what I observe. Three, I have the ability to challenge my thought processes to ensure that what I believe is not an illusion. Lastly, I like solving puzzles. So now, some 45 years later, I lead the global forensic investigation practice of a top ten CPA and Advisory Firm and do my best to help organizations fight fraud. Here's how it all began!

In the summer of 1979, my family was invited to spend the week with friends on the Jersey Shore. I always liked going to the beach because our host had a boat and would take us fishing. One night around sunset, I was sitting on a dock bench and heard two men speaking. I turned and noticed some younger men in their mid-twenties wearing jeans and hoodies walking up and down the dock, commenting on various boats. I remember laughing out loud and wondering why these two guys would dress like that; the temperature is over 90 degrees!

Later that night, I was sitting in our host's living room watching the evening news, and a story ran about a string of robberies. I listened intently and understood that someone was boarding boats docked in slips and stealing radios, fish finders, and other equipment.

The following day at breakfast, our host spoke about the story, how this was a real problem for the local community, and how thankful they were that nothing happened to them. Later that day, I returned to my spot on the dock to watch the sunset and saw the same two men dressed in the same clothes. I remember pulling down my baseball cap and watching them walk by several slips and whisper to each other, and then about twenty minutes later, I witnessed them getting into a white van and driving away. I was now suspicious, so I traced their walking route looking at the boats they seemed most interested in. Of course, these were the more expensive boats.

The next day I remember sitting in the kitchen, and our host came in, and he was furious. The host picked up the phone and made a call. After a few seconds, I listened and knew the police were on the other end of the line. The host said, "They got us. . .our radio and other equipment

are gone!" I felt horrible for them. Later that day, I asked my Dad if he could come with me to my spot and watch the sunset. My Dad and I walked and sat on the same bench, and I turned to him and said, "I might know who robbed our host."

My Dad, a CPA, and a very bright man turned to me and said, "Prove it." So, I explained what I observed, and after listening to me, he said, "Let's go." I didn't know what to think? We walked briskly to the host's house, and my Dad explained what I had told him. We all then jumped into the car. I asked, "Where are we going?" My host replied, "To the Police Station."

About 10 minutes later, we arrived at the Police Station, and after a few minutes, I was in a room with my Dad, the host, and a Detective, who looked at me and said, "Well?" I told my story, but this time I added in all the details of the men and the van they were driving. The Detective challenged me along the way, and at one point, he asked me how I knew the men were less than 6 feet tall. I told him there were flags on the dock and when I observed the men walking by, their heads were below the flags. I went on to tell the Detective that I was 5' 8," and my Dad was 6'0". My Dad's head was in line with the flags, and mine was below; so, I assumed they were less than 6'0" tall. The Detective laughed and said, "Smart young man" while looking at my Dad.

The Detective then asked me if I had anything else that could help them, and I rattled off the license plate of the van. I remember watching my Dad, our host, and the Detectives faces light up as if I had given them the winning numbers to the lottery. The Detective ran the plate and then told us he would be in touch.

The next day, the Detective came to our host's house and told us they were going to run a sting operation. That night I remember watching Johnny Carson, and there was a knock on the door. It was the Detective with our hosts radio. He asked if I could come down to the Police Department and my Dad said, "Absolutely." So, the next morning, we drove back to the Police Station where I was greeted by several officers who were applauding me. I then went out front and got in the Detective's car and we drove back to our host's house with lights and sirens! My Dad was following behind. After I exited the vehicle the Detective looked at me said, "Well done young man," and off he drove.

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According to US Legal.com, a Daubert challenge is a hearing conducted before a judge where the validity and admissibility of expert testimony are challenged by opposing counsel. The expert is required to demonstrate that his/her methodology and reasoning are scientifically valid and can be applied to the facts of the case. The term comes from the 1993 U.S. Supreme Court case, Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993), in which the Court articulated a new set of criteria for the admissibility of scientific expert testimony. In its 1999 Kumho Tire v. Carmichael

opinion, the Court extended Daubert's general holding to include nonscientific expert testimony as well.[1] An expert who expects to testify in civil or criminal court about his or her work needs to be aware of and prepared for a Daubert challenge.

In a 2017 *Fraud Magazine* article, John D. Gill, ACFE Vice President of Education, penned an article titled: "The Fraud Triangle on Trial." In his article, Gill examined several U.S. court opinions that refer to the fraud triangle and was surprised to find cases where judges denied the admission of expert testimony about the triangle because they deemed it to be "unreliable" scientific theory.[2] The following are excerpts from Gill's summaries of three cases:

- *Haupt v. Heaps*, 131 P.3d 252 (2005). The appellate court "failed to locate even a single case in which the 'fraud triangles' [sic] theory has been adopted as a reliable scientific method in any court of law." The (fraud triangle) evidence was rejected for that reason and because the court felt the testimony was more prejudicial than probative.
- *Travis v. State Farm Fire & Cas. Co.*, 2005 U.S. Dist. LEXIS 49957. "The trial judge excluded the (fraud triangle) testimony." In his opinion, the judge notes that applying the triangle relies more on professional judgment than "hard science." The judge writes, "it is also unlikely that there is a known rate of error or specific objective controls associated with the application of the fraud triangle." Further, Gill paraphrasing the judge: "expert evidence from fraud examiners is usually related to direct evidence that fraud has occurred or to descriptive evidence that will help the jury understand transactions and how they compare with or deviate from applicable standards."
- *Kremsky v. Kremsky*, 2017 U.S. Dist. LEXIS 22794. In its opinion, the court notes that an expert witness can't speak to the subjective belief of a party because it would basically amount to unsupported speculation. The court writes, "Uncle [Stanton Kremsky] does not cite a case where an expert touting this 'fraud triangle' has been permitted to opine as to motive." It further stated, "An expert cannot speak as to the subjective belief of a [party]."

Both the Daubert challenge and Gill's cautionary tale are relevant to those professionals who conduct fraud examinations, especially those who give expert testimony in a court of law.

We'll examine these and other topics associated with the legal, regulatory, and professional environment across several modules. Those modules, along with the learning objectives, include the following:

- Module 1 provides an overview of the criminal and civil justice systems within which forensic accountants and fraud examiners operate. The objective is for the reader to be able to differentiate between the criminal and civil legal systems and to begin to develop an appreciation for the complexities of pursuing legal action.
- Module 2 outlines the legal rights of individuals based on the U.S. Constitution. The goal in this module is for readers to be able to discuss the legal rights of individuals—related to

employment, interviews, searches, surveillance, privileges, and standards—under the U.S. justice system.

- Module 3 takes a look at U.S. Constitution Fourth Amendment rights associated with probable cause. The goal here is for the reader to identify the requirements associated with probable cause when collecting evidentiary materials.
- Module 4 reviews the rules of evidence by considering the primary attributes of evidence, particularly those that allow evidentiary materials to be presented in a court of law. The takeaway from Module 4 will be the reader's ability to describe the role of evidence and the elements to meet the criteria of what constitutes "evidence."
- Modules 5 and 6 offer overviews of the criminal (Module 5) and civil (Module 6) justice systems. The learning objective of these modules is for the reader to recognize the legal environment in which he is working and be able to articulate the similarities and differences of each system.
- Module 7 takes an initial dive into basic accounting, including financial statements, offering a survival guide for those with more of a criminal justice, legal, or regulatory background, who have less familiarity with accounting principles. The goal here is to launch readers on a path toward the utilization of accounting data in forensic accounting engagements and fraud examinations.
- Module 8 provides an overview of the key elements of the regulatory system in which financial information is developed, particularly financial statement information. Readers will be able to describe the primary environment in which financial numbers are developed and presented.
- Module 9 provides an introduction to key organizational stakeholders, who oversee the development of accounting information, including responsibility for the internal control environment. The objective is for readers to identify the key players within the environment in which financial and nonfinancial information is generated.

MODULE 1: INTRODUCTION

Fraud may be prosecuted criminally or civilly. Almost any dispute between entities (individuals, businesses, organizations, government entities, etc.) can be prosecuted in civil court. Any time the legal issue at hand involves money, an opportunity arises for forensic accountant involvement. Similarly, any time the legal issue involves claims of fraudulent activity, fraud examiners and forensic accountants can play an important role in investigating and resolving the issue. In either case, the process begins when one or more parties make a claim against another.

In the criminal justice system, a person from the private sector may report a crime. Individuals, families, neighbors, businesses, charities, nonprofits, associations, industry, newspapers, TV, radio, and the Internet are some of the sources where a legal issue may come to light. These same

organizations are part of the crime prevention fabric as well. One of the major crime prevention tools is the fear of getting caught. In fact, it is generally accepted that this fear is a greater deterrent than the fear of punishment. Most people think of law enforcement when they consider the legal environment, but other entities often play a part as well, such as public health departments, educational institutions, welfare and social justice organizations, public works departments, and public housing. The watchful eye of those members of the greater community is critical to the success of both the criminal and civil justice systems.

Furthermore, members of the community directly participate in the civil and criminal systems. They report crimes and civil actions; they serve as witnesses, jurors, and other officers of the court. One of the most important aspects of the American and Western judicial systems is the willingness to accept the outcomes of the legal process. Both sides to an issue are committed to their position; that is why they are in the civil or criminal justice system to begin with. Both sides commit considerable time and economic resources to pursuing their goals and positions. Yet despite the battles waged inside our courtrooms everyday— from local magistrates to the U.S. Supreme Court— when the final verdict is announced, generally the participants and society at large accept the outcomes. Another interesting aspect of our legal system is that most people are law-abiding citizens. If desired, many could get away with relatively minor crimes periodically and possibly even major crimes. But the vast majority of Americans and citizens of Western society agree to "play by the rules" because they believe that while some legal outcomes may be less than perfect, generally the system works, and our society is better off if everyone follows the rules.

Criminal cases are brought forth by the government through the criminal justice system. The government apprehends, tries, and punishes convicted individuals for criminal behavior. The foundation for this approach is that criminal behavior is considered a "crime against the state" as well as against individual victims. If the victims or others with a stake in the outcome are not satisfied with the results of the criminal justice system, they may pursue their claim through the civil justice system. Cases may also be pursued criminally and civilly at the same time. The primary difference between the criminal and civil systems is the potential remedy for the victim: the primary allowable remedy in the civil process is monetary damages, whereas the criminal justice system may result in fines, community service, probation, incarceration, censure, and even capital punishment. In the United States, however, there are no fraud crimes that carry the death penalty.

Most criminal cases never end up in the *criminal justice system*. This is known as the *criminal justice funnel*. The funnel analogy is derived from the fact that while many crimes go in the top at the wide part of the funnel, few come out at the bottom in the form of convictions and incarcerations. In fact, most crimes are not discovered, and many that are discovered are not reported. Reports from victims, other citizens, law enforcement personnel, informants, investigators, and intelligence activities may result in the observation of criminal behavior. Nevertheless, there is a tremendous amount of discretion inherent in the American and Western criminal justice systems. Just because a

criminal or civil offense is observed does not mean that it will be reported or pursued. Even if an actual crime in observed, before the criminal justice system can pursue the matter, the suspect must be identified and apprehended.

In addition to the criminal and civil justice systems, regulatory agencies also play an important role in monitoring illegal activities and pursuing those responsible. The U.S. Securities and Exchange Commission (SEC) regulates securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. The SEC may bring civil or administrative actions to seek remedies for violations of law or the Commission's rules, and works closely with law enforcement agencies to bring criminal cases, when appropriate. The Public Company Accounting Oversight Board (PCAOB) was created by the Sarbanes–Oxley Act of 2002 to oversee the auditing firms of public companies. Its main purpose is to protect investors by promoting fair and informative financial reports. The board members are appointed by the SEC.

Governmental agencies regulate activities involving utilities, communications, and air transportation, to name a few. Taxpayer money provides the resources needed for government operations, and the Internal Revenue Service (IRS) is charged with collecting those taxes and enforcing the tax laws under the Internal Revenue Code. The IRS can also bring actions against taxpayers in civil and/or criminal court for noncompliance with the tax code.

MODULE 2: THE RIGHTS OF INDIVIDUALS

In this section, we discuss the right of the individual, particularly those persons accused of or potentially accused of committing a crime. Paul Cassell suggests that the "criminal justice system is shifting, at least to some modest degree, from a two-sided, 'State v. Defendant' model to a three-sided model in which crime victims are free to enforce their own rights." Mr. Cassell suggests that "this change is long overdue, as crime victims have their own independent concerns in the process that ought to be recognized."[3]

In defense of his position, the author cites *Paroline v. U.S. & Amy*. Amy's attorney submitted a detailed restitution request for Amy, a victim of child pornography crimes. The request was supported by a forensic psychological evaluation and econometric projection. Amy sought restitution in the amount of $3,367,854 for lifetime psychological counseling costs and lost income. The government supported Amy's request. Following two evidentiary hearings, the district court denied Amy, finding that it was not possible to identify precisely what part of those losses was specifically attributable to the defendant, Paroline, as opposed to thousands of other criminals who were victimizing Amy. However, Amy sought review in the U.S. Court of Appeals for the Fifth Circuit that remanded the case to the district court for an award of full restitution.

When persons consider individual rights, most of those rights are associated with formal actions in the criminal and civil justice environments. Generally, individuals have far fewer rights as

employees than as citizens. Most fundamentally, individual rights are grounded in four amendments to the U.S. Constitution associated with due process:

- The Fourth Amendment prohibits unreasonable searches and seizures
- The Fifth Amendment provides that a person cannot be compelled to provide incriminating information against himself in a criminal case
- The Sixth Amendment provides that an individual has the right to an attorney to defend himself and the right to confront witnesses against him
- The Fourteenth Amendment entitles a person to due process of law and equal protections under the law

As employees, individuals have an obligation to cooperate with their employer or be subject to dismissal. Other rights may be granted to employees as set out in employment contracts and collective bargaining agreements. Federal law and many state laws protect employees who report improper or illegal acts of their employer. Such laws normally protect the employee against overt retaliatory or punitive action by the employer, although as a practical matter, subtle forms of discrimination are hard to combat.

Interviews

An employee's or individual suspect's right to avoid self-incrimination applies to employers, investigators, and law enforcement personnel. An employee who refuses to cooperate during an interview while invoking the Fifth Amendment, however, may be subject to employment termination. In custodial settings by law enforcement, and in those settings where the suspected perpetrator has been taken into custody and denied freedom presumably against their will, federal law may require that a Miranda warning be read to the suspect.

Because employers do not have the right to place employees in a custodial setting, an employee has limited Fifth Amendment rights. Public employers, however, are held to a higher standard, and their employees can invoke their Fifth Amendment protections without fear of reprisal.

The Miranda warnings consist of the following:

- The interviewee has a right to remain silent
- The interviewee's answers may be used against him
- The interviewee has a right to an attorney
- If the interviewee cannot afford an attorney, one will be provided at no cost
- The interviewee can decide at any time to invoke these rights

A second issue arises regarding employee interviews under the Sixth Amendment, and whether the employee has a right to legal counsel. As long as a nonpublic entity is conducting the interview, an employee does not have the right to have a lawyer present, nor does the employee have the right to