



FORENSIC ACCOUNTING

Test Your Forensic Accounting IQ

By D. Larry Crumbley, CPA, CFFA

Gordon Brown, then the Chancellor of the Exchequer in UK, said in 2006 that “what the use of fingerprints was to the 19th century, and DNA analysis was to the 20th, forensic accounting will be to the 21st century.” Find out if you are equipped for the new century by taking this quiz, the first of a series of occasional Forensic Accounting IQ quizzes that will appear in the *Examiner*. **Answers appear on page 46.**

1. Forensic accounting is the same as fraud investigation.
 - a. True
 - b. False
2. What statement is *false* about an expert witness who is qualified to testify in court?
 - a. He or she must have specialized knowledge, training, experience, or other qualifications (for example, writings) in a subject outside the average person’s understanding.
 - b. The judge must determine whether the witness has the qualifications needed to testify in the case.
3. Valutors and forensic accountants should look for fraud red flags in journal entries, source documents, and ledgers. Which item is not a source-document fraud symptom?
 - a. Unexplained adjustment
 - b. Photocopies of missing documents
 - c. Counterfeit/false documents
 - d. Excessive voids/credits
 - e. Second endorsements
4. What is the indirect balance sheet approach that the IRS used to put Al Capone behind bars for not paying his income taxes?
 - a. Source and application of funds
 - b. Bank deposit method
 - c. Expenditure method
 - d. Net worth method
 - e. Ratio analysis formula
5. A _____ system (or test) can detect forged checks having duplicate serial numbers and voided checks presented for payment.
 - a. Attribute sampling
 - b. Positive pay
 - c. Duplicate number
 - d. Aberrant pattern
 - e. Rounded number
6. Forensic accountants look for suspiciously rounded numbers to spot possible fraudulent activity. In which area would too many rounded numbers arouse suspicion?
 - a. Travel & entertainment expenses on tax returns
 - b. Inventory counts
 - c. Regulatory filings
 - d. Accounts receivable balances
 - e. All of the above
7. A pleading that disputes the legal sufficiency of a complaint is called
 - a. Cross-complaint
 - b. Demurrer
 - c. Pro se
 - d. Interrogatory

8. Which would *not* be related to off-the-books fraud?
- Scrap inventories
 - Kickbacks
 - Skimming
 - Duplicate payments
9. Which would probably *not* be an indicator of an *alter ego* situation?
- Zero balance account or sweep account in a subsidiary
 - Undercapitalization of a subsidiary as a result of operating losses
 - An inability of a subsidiary to obtain credit from sources other than its parent
 - The parent and subsidiary use identical letterhead or letterhead with both parent and subsidiary's names
10. You are engaged to value a large manufacturing company, and you are presented with a list of 1,751 large assets of the company. According to probability, what percent of the assets would have initial digit be a 9?
- 4.6
 - 7.9
 - 9.7
 - 17.6

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TO SPEAK OUT

ANSWERS TO "TEST YOUR FORENSIC ACCOUNTING IQ" QUIZ ON PAGES 44-45

1. False. Fraud investigation is a small part of forensic accounting. The 1986 AICPA Practice Aid No. 7 broke litigation services into six broad areas: damages, anti-trust, accounting, valuation, general consulting, and analyses. Fraud was only one of 40 subcategories. Zeph Telpner and Michael Mostek say a forensic accountant has extensive experience in investigations to determine solutions to disputed accounting matters, to write expert reports on their investigation, and to appear in court as expert witnesses.

2. (d). An expert witness can testify about documents that have *not* been entered into evidence if they are of the type normally relied on by experts in that field to form an opinion. An expert witness can testify about hearsay evidence as long as it is something that is normally relied on by experts in the field.

3. (a). Unexplained adjustments would be a journal-entry fraud symptom, not a source-document fraud symptom. Other source documents fraud symptoms include:

- Duplicate payments
- Large numbers of reconciling items
- Older items on bank reconciliations
- Ghost employees
- Lost register tapes
- Lots of round numbers

4. (d). Over the years the IRS has developed a number of indirect methods which use economic reality and financial status techniques in order to reconstruct a person's finances through circumstantial evidence. The net worth method is a common indirect balance sheet approach to estimating income of people like Al Capone who deal only with cash. To use the net worth method, an IRS agent or forensic accountant must:

- Calculate the person's net worth (the known assets less known liabilities) at the beginning and ending of a period.
- Add nondeductible living expenses to the increase in net worth.
- Account for any difference between reported income and the increase in net worth during the year as (a) nontaxable income and (b) unidentified differences.

The Supreme Court in *Holland v. U.S.*, 348 U.S. 121 (1954) has upheld the net worth method. Accountants may use this technique in divorce situations, with embezzlers and other fraudsters.

5. (b). Under a positive pay system a business installs software on their computers which sends data about written checks to their bank. A positive pay system can detect forged checks having duplicate serial numbers, voided checks presented for payment, stale checks, checks with altered or invalid amounts, and checks with altered payee lines. The bank calls the company before honoring suspected checks. This anti-fraud tool eliminates the need to review each check which helps businesses gain control of the exception process and reduces write-offs. Positive pay can even be integrated into a bank's branch system to detect fraud at the teller window or platform.

6. (e). Too many rounded numbers in all of these listed areas should alert a forensic accountant to possible fraudulent activity.

7. (b). If a defendant believes that a plaintiff has not met the legal standards of a complaint, a demurrer may be filed. The defendant suggests that although the facts may be correct, no cause of action exists which imposes any legal liability on the defendant.

8. (d). A duplicate payment is an example of an on-the-books fraud. Often an employee will initiate, with criminal intent, the necessary documentation to cause additional payments to be made to a contractor or vendor. Thus, there is evidence in the

books that a fraud has occurred. An off-the-book theft of assets are not recorded in the books (e.g., scrap inventory that has not been capitalized or skimming cash before it reaches the cash register).

9. (b). The *alter ego* or "second self" theory allows a court to pierce the corporate veil and hold the controlling force behind the corporation responsible. One of the most litigated areas in corporate law, *alter ego* provides an equitable remedy to allow a plaintiff to obtain a judgment against a corporation that a plaintiff would have no standing to sue. Accountants are in an excellent position to locate and testify about the indicia of *alter ego*.

10. (a). Benford's Law states that the distribution of initial digits in a list of numbers is not uniform. For example, the first digit will be 1 almost 33 percent of the time, and as digits get larger they occur with lower frequency. Software is available to detect potentially contrived numbers in many situations. Even without software, an accountant can sometimes count the percentage of initial nines to help detect faked numbers. (Frank Benford, a physicist, stated the law in 1938, but it had been previously stated by Simon Newcomb in 1881.)



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