

## FTI AND FORENSIC ACCOUNTING TUESDAY SEPTEMBER 21, 2004

**DONALD LANGEVOORT:** Good morning. I'm Don Langevoort, Thomas Aquinas Reynolds Professor of Law at Georgetown University and host of the Fireside Chats, Securities and Exchange Commission Historical Society. The Securities and Exchange Commission Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC, and of the securities industry through its virtual museum at [www.sechistorical.org](http://www.sechistorical.org). Today's chat will be preserved in the museum, so you can listen to the discussion or read the transcript later.

Today's Fireside Chat looks at forensic accounting with James Barratt and Ernest Ten Eyck of FTI Consulting, Inc. Both Jim and Ernie are CPAs and Senior Managing Directors in the forensic and litigation consulting practice for FTI. Jim is based in Washington, Ernie in King of Prussia, Pennsylvania. This chat is made possible through the support of FTI Consulting, Inc. The remarks today are solely those of the speakers and not representative of the Society. Our speakers cannot give legal or investment advice. I'd like to thank our museum visitors who've sent in questions, which I'll get to later in the conversation. Well, thank you for coming today.

Let me ask the basic and obvious question: what is forensic accounting? What's the scope of what a forensic accountant does?

**JAMES BARRATT:** Well, I guess I would define forensic accounting as the practice of using accounting, auditing and investigating skills to assist in legal matters, and that is really forensic, the word capable of being used in courts relating to legal matters. So, essentially a forensic accountant is an individual with accounting expertise that can use that expertise in the course of investigations or legal matters to then render some type of finding or opinion.

**DONALD LANGEVOORT:** So how does it usually come up? Litigation arises and you're brought in to figure out what? Tell me about the game plan of the forensic accountant once you're asked to do some detective work. Ernie?

**ERNEST TEN EYCK:** Well, in the context of litigation, it usually involves doing an investigative-type of forensic examination, if you would, on the facts of the case that you're really using the discovery process as the means of doing your investigation, and usually working for counsel, of course in a privileged kind of role. So, your purpose in life is to advise the litigators of what the bona fides of the case are, perhaps from the defense or the plaintiffs' side from a financial reporting/accounting-type standpoint.

**DONALD LANGEVOORT:** And how do you do the work?

**JAMES BARRATT:** Very carefully. [laughter] Well, typically what we'll do is come in and get an assessment of what the issues are, partner up, as Ernie says, with a law firm or lawyers to then dig in to whatever the issue is. It may be the accounting treatment of certain transactions, and we need to go back in and through interviews, through reviewing documents, really gain an understanding of what happened, find out who was involved and how things occurred. Many times it draws upon the interview skills, and sometimes attorneys can do interviews, but they don't necessarily have the accounting or auditing background in order to really drill down into what the answers are.

**DONALD LANGEVOORT:** So you're looking at the judgments that were made, whether the records were properly kept, all of those issues. Do you sometimes get involved with lawyers wondering whether something went wrong as opposed to somewhere on down the line in a litigation construct? So that you're really rendering advice on whether this ought to be pursued at all.

**JAMES BARRATT:** Sure. Yes, sometimes, and probably more recently you'll see a lot of whistleblower letters that will come out, and many times it could be just a disgruntled employee or someone trying to create some trouble, and we may be brought in just to really look at it and see what the issues are and try and make an early assessment in that regard.

**DONALD LANGEVOORT:** And then I suspect somewhere in the middle between the actual litigation, also the work of special committees of boards of directors or audit committees is increasing the demand for forensic accounting, and you'd be part of that kind of investigation.

**JAMES BARRATT:** Absolutely. That's quite a bit of our work in our practice at least more recently, has been working through lawyers on behalf of the audit committee. And one case that I can talk about today is one that involved Freddie Mac, where we were brought in to work on behalf of the audit committee through the Baker Botts law firm. And there it started out as a whistleblower letter in December 2002; we thought we might be able to get it done and go home in time for Christmas, but it turned out that there wasn't much to the whistleblower allegations, however, during the course of that, it turned out that there were some items that needed restatement in their financial statements.

**DONALD LANGEVOORT:** And that came about because of the investigation?

**JAMES BARRATT:** Partially, but really independent of that they had some new auditors that were in and were looking at some transactions, and so the company had decided that they needed to restate. And so then we were brought in to look at the items of restatement. There were several transactions and policies that had been followed and so we were really working hand-in-glove with the attorneys to find out really the who, what, when, where, related to these transactions. And we started after Christmas this time, and went, this was a fairly lengthy investigation, but went for several months, and during the course of that, we really conducted what's the equivalent of probably of what we used to do at the SEC, in terms of SEC investigation. Many times we'll be brought in and we tend to work as a shortcut if you will, to go in and do the investigative work that the SEC normally would do. We sometimes can get in there and do it more quickly with less red tape if you will.

So, in the case of Freddie Mac, we looked at all the different transactions, we interviewed almost 200 individuals, we reviewed a lot of electronic information which nowadays is really vital to forensic accountants and forensic accounting investigations, and out of that we assisted the law firm in producing a report that then went to the audit committee, and then they could take remedial measures as they saw fit. And during the course of the investigation, we also met with the staff of the SEC, Congress, interested parties, to indicate what we had been finding.

**DONALD LANGEVOORT:** How does what a forensic accountant do differ from what an auditor does?

**ERNEST TEN EYCK:** Well, people tend to think of accountants and auditors, I think, as precise, painstaking people, but a forensic accounting investigation tends to be excruciating in its detail and the things it chases, depending on how your client wants to pursue certain matters. There has been a move afoot for sometime now for auditors to incorporate more types of forensic procedures into ordinary audits. One of the interesting questions that come up is how do you distinguish a forensic procedure from an ordinary auditing procedure, and I'm not sure I know the answer to that question.

**DONALD LANGEVOORT:** And that's something the profession is working on.

**ERNEST TEN EYCK:** Yes, it's something it's working on. There's a discussion memorandum on the street now; I think there's a roundtable tomorrow here in Washington, DC, on that very topic. But the biggest thing I think and the discussion memorandum gets to this in a couple of ways, is that it's a different mindset. You know, auditors generally are skeptical, but they're not out to get the goods on management. Forensic accountants usually are out to see if there are any goods to get on management and it's a different attitude.

**DONALD LANGEVOORT:** Right. So in some sense, what you're looking at is not simply whether generally accepted accounting principles were adhered to, whether the financial reports were right, but the why question: was there a level of culpability? Was there a level of intentional deliberate wrongdoing that might lead to serious legal consequences in litigation with either the SEC or criminal prosecution?

I'd like to sort of follow up on that. Obviously you've done a lot of forensic investigations, and people who are listening have read the press in the last two or three years about all the financial reporting scandal. We've gotten all sorts of takes on what happened. Why was it that financial reporting crumbled so badly in some of these big companies? And I'd be curious to hear you talk a little bit based on your experience about why you think people inside these organizations succumb to pressure, or cut corners, or did what ended up to be such big visibility scandals?

**ERNEST TEN EYCK:** I think the biggest part of it is sort of a corporate culture tone at the top attitude that developed during the '90's, where senior management, particularly of successful companies, reached the point where they thought they could get away with anything.

**DONALD LANGEVOORT:** Why was that? Why did they think that?

**ERNEST TEN EYCK:** I'm a forensic accountant, not an organizational behaviorist or a psychologist. I think it's the arrogance of success, more than anything brought that on, to use a non-technical term. And when things didn't go so well in the business, they either saw nothing wrong with it, or thought they could get away with simply fudging the numbers to make up the difference, in some cases in massive kind of ways.

**DONALD LANGEVOORT:** And was that a commentary in part on the degree of enforcement and regulation at the time? I mean, if you think you can get away with it, you're assuming that nobody from the Justice Department or the SEC is likely to come in and really come down hard on you. Was that part of the perception, do you think?

**ERNEST TEN EYCK:** I think Jim may have his own take on this, I think people who behave in those kinds of ways, never think about getting caught.

**DONALD LANGEVOORT:** It just doesn't occur to them.

**ERNEST TEN EYCK:** It simply never crosses their mind. It happens to other people, not to me kind of perspective on life. And I don't know that there was any particular laxity in the regulatory framework. Most of this was invisible to the regulatory framework. I mean you needed that whistleblower entrée kind of thing with a few exceptions. I mean, there were some companies who you could read the notes to the financial statements and you could have two PhD's and a CPA, and not understand what they were talking about.

**DONALD LANGEVOORT:** And that would be Enron.

**JAMES BARRATT:** Yes. I agree with Ernie. I think especially when people are committing fraud, they don't necessarily think they're going to get caught, and therefore get away with it. But sometimes, it's just a quick fix. They've had something happen in the business, and it's a one-time thing and they think to themselves, well, I'll just do it this one time and then we'll correct it and then we won't ever have to deal with this again, and it won't be at year-end, therefore the auditors won't necessarily be scrutinizing this and we can get away with it. I think another factor, to get back to your question is the emphasis for public companies in kind of meeting their numbers, and a lot of the earnings management cases, if you will, go to in response to pressure from the street, the street's expectations in terms of what earnings per share will be. And so companies many times would cut corners or be somewhat aggressive to make sure that they were meeting the financial results, that not necessarily were a product of the company's operations, but more so what the street's expectations were.

**ERNEST TEN EYCK:** Hence cookie jar reserves and such things as that where you could level your earnings without necessarily changing any of the fundamentals of the business.

**DONALD LANGEVOORT:** Yes, a lot of the portrayals of people, and we can name companies or not, all the names are in the news, make it seem like these are stories about executives in a horribly corrupt fashion, cheating the investing public. When you get into the nitty-gritty of all of these things, does it strike you as corruption and evil, or something a little bit more mundane?

**JAMES BARRATT:** I think there's a combination. Sometimes it's corruption, sometimes it's incompetence, sometimes it's lack of attention to detail. Sometimes you'll find companies

that really didn't have a very robust accounting and finance group, and when you're interpreting accounting standards, there's a fair amount of judgment and so sometimes innocently you could go along the wrong path. Other times, people may try to exploit kind of a loophole in some of the literature.

**DONALD LANGEVOORT:** I want to go back to something Ernie was talking about. Before you mentioned that the profession is still trying to think through what the relationship between forensic accounting and auditing really is, and you mentioned that there has been a report prepared under the auspices of the AICPA, and I guess one of the issues that comes out of it is whether forensic accountants ought to be drafted more away from the litigation support and the assisting the special committee or audit committee of a board of directors, and become more actively involved in the audit function itself on an ongoing basis. Is that a fair statement of at least one of the issues that's being considered right now?

**ERNEST TEN EYCK:** Clearly. I mean the panel on audit effectiveness came forth with that recommendation, and when they wrote the latest iteration of the fraud standard for generally accepted auditing standards, it says the auditor should consider whether or not he needs to bring in that forensic accountant.

**DONALD LANGEVOORT:** I guess I'd like to follow up on that because that fascinates me. Consider whether is an awfully broad direction. How does one consider whether to?

**ERNEST TEN EYCK:** If your auditing a plain vanilla, highly transparent company with apparently honest management and a good control structure, why in the world would you want to bring in a forensic accountant? It seems to me that it makes the most sense when you have a more high-risk situation, where the audit risk is high, and not necessarily because you have some indication that a fraud has taken place, but just because of the high risk, you might pick one or two areas and bring in a forensic accounting team to assist in that area. I know that's happened in a few cases where the big accounting firms have been using their forensic accountants who by and large have been a separate practice. It's just a whole separate operation, as if it were a different department. But you're starting to see a little bit of that and I think it's being encouraged certainly by the regulators. What the Public Company Accounting Oversight Board ultimately will have to say about that remains to be seen. For the 15,000 public companies, they are in charge of auditing standards now, not the AICPA.

**DONALD LANGEVOORT:** Okay. Right.

**JAMES BARRATT:** I think, my thoughts on that, the auditing standards have developed over the years, and in terms of the auditors' responsibility or tasks they should do in order to determine whether fraud may be a possibility in a company, and I think with the addition of SAS99 and kind of putting it on a higher level to the auditors.

**DONALD LANGEVOORT:** Could you elaborate on that and just take me historically through what was expected in terms of fraud detection 20 years ago compared to where we are in 2004?

**JAMES BARRATT:** Ernie, you might have an historical perspective on that.

**ERNEST TEN EYCK:** I have a little bit of perspective on that since I was a member of the Auditing Standards Board when those standards were first strengthened in 1988. It's been an evolutionary process. It wasn't until the last few years that the F-word, fraud was actually used in the context of the auditing standards. We always spoke euphemistically of irregularities, but they tend to be the same thing. Now that terminology has some problems because in the accounting world, there's only two ways that the financial statements can get boxed up. It's either on purpose, or it's not on purpose, and to use the term fraud to describe something that was simply on purpose is really substantially different than the legal concept where there's some state of mind intended. But it's been an evolutionary process where the regulators in particular have been pushing very hard for the auditors to take more responsibility to find fraud and rightfully so, I think. There is an expectation out there on the part of people who use the auditors' work product that if there's a clean audit report on the financial statements, there

should be very, very low risk that somebody is intentionally manipulating the financial statements.

**DONALD LANGEVOORT:** Is this also a political story, I mean, going back 20 or 30 years, in the 1970's as a result of Watergate and the adoption of the Foreign Corrupt Practices Act?

**ERNEST TEN EYCK:** There's always some blow-up that moves the standard setters to the next notch. Always.

**DONALD LANGEVOORT:** And is there organized resistance to the idea of a greater attention within audits to the F-word, as you described it?

**ERNEST TEN EYCK:** My sense is that there's no organized resistance. The fear of litigation is what drives the resistance to the extent that there's been resistance. The more responsibility that you take and appear to take, the more risk you run of being sucked into one of these giant accounting scams and becoming a defendant with an enormous number of zeros after your potential liability.

**DONALD LANGEVOORT:** Sure. I want to get to a question that Michael McConnell sent in that I think relates to exactly what we're talking about, and uses another phrase that I think is important in understanding issues like this. He is talking about the current debate over the use of forensic accountants, and he says that this discussion about whether forensics can be used to help auditors of companies and companies' management bridge the expectation gap between the public's expectation of the purposes and objectives of an audit and a CPA's responsibilities under generally accepted auditing standards. Does, and he uses the word expectation gap, and it taps into a debate that's been going on for a long time about whether the investing public unrealistically expects that accountants and auditors can really find fraud and really intervene to prevent it, such that if you see fraud happening, it must be that the accountants and the auditors screwed up? Do you think that this debate about getting forensic accountants further in depth into the fraud detection process is going to heighten expectations unrealistically, or is it a good way of addressing the expectations gap? That's a hard essay question.

**ERNEST TEN EYCK:** My sense is that it can only help in terms of closing the gap from the profession's direction. But the harsh truth of the matter is that, did the senior management intent on committing fraud that's really bright and knowledgeable about things. If I'm the CEO of the company and Jim is the CFO of the company, Lord help all the shareholders, because we could pull off a massive fraud and they wouldn't catch it. You have to understand, there's limits, and that's the other side of the expectation gap. Frankly, I think the accounting profession has done a miserable job of educating the public about the limitations of audits and internal controls and other things that supposedly would underlay all the expectation gap issue, which is a term, by the way, that we used in the mid 1980's when we thought we were fixing the problem.

**JAMES BARRATT:** Yes. I think in terms of expectation, I think Ernie touches on it too, is that a lot of this can be from the management perspective at the company. I mean, obviously it's management's financial statements, and they're supposed to put them in accordance with GAAP and then the auditors kind of opine on that, and I think in terms of forensic accounting, one thought I had is just more if the internal audit function of a company, say had more of a forensic accounting type vent, where they're not, it's difficult because you're within the company and you're trying to help it, but at the same time, if it was a little more critical look at things internally before it even reaches the auditors may preempt a fair number of these things.

**DONALD LANGEVOORT:** I think that gets into another question that we can spend a little bit of time on, which is the relationship, and we talked about the audit, but the new standard imposed in the last year as a result of section 404 of Sarbanes-Oxley is the design, the architecture associated with systems of internal financial reporting controls and internal accounting controls, and I suspect lots of people are still wondering what a reasonable system of internal controls under the new regime is supposed to look like. Are you suggesting, and I

think you are, that maybe part of the design of control architecture should be some team of people who can be sent to work doing forensics?

**JAMES BARRATT:** Well, in fact, there are some companies that do have investigators within the company. I'm just suggesting that maybe an internal audit's kind of traditional role, depending on the company, many times they were there just to look at the, if you had to, say for example, the information technology systems, to check them, and sometimes didn't even reach the point of looking at how things were accounted for in accordance with GAAP. So it's kind of a second check, if you will, on maybe the finance function. But I think, section 404, that'll be interesting to see. I know many companies and audit firms right now are going through this difficult and arduous process and many people don't know how it's going to come out. It's very much a question mark at this point.

**DONALD LANGEVOORT:** How do you think it should come out? I mean, if you were helping guide policy in this area, what guidance would you give to a company, or to the profession about the depth of control?

**JAMES BARRATT:** Well, I'm not sure I'd have any specific guidance. I think going back to one point Ernie made is regardless even of how well you design or describe internal control, there's always going to be ways that it can be gotten around, whether collusion or what have you, so I think part of it I think is getting the detail controls. It's also, as Ernie mentioned, the tone at the top is really getting the buy in from senior management, the board, that this is a priority that we're going to have strong internal controls. We're going to follow the accounting literature, and that may help to eliminate some of the problems.

**ERNEST TEN EYCK:** I think you're seeing more and more emphasis on that function because it starts with Sarbanes-Oxley 404. Then you have the SEC rules, and the peek-a-boo rules on top of that, but what happens is that everybody goes for framework. The framework is invariably COSO. COSO drives you towards an internal audit function because part of, one of the major elements is a monitoring function that continued to keep an eye on whether the controls are still working or not.

**DONALD LANGEVOORT:** And that's a process that's been going on since the Treadway commission in the 1980's, so we're not talking about a new phenomenon.

**ERNEST TEN EYCK:** Right. It's not new, but we certainly have not seen virtually every public company force the move in that direction up until now, and if there's going to be a sea change that takes place, I think Sarbanes-Oxley probably will be what brings it about. I must tell you that in the current environment, I would not be a member of an audit committee of a company that did not have a strong internal audit function. Somebody's got to report to me besides management that's keeping an eye on the shop. And I would insist on that.

**DONALD LANGEVOORT:** Right. Let's take that thought a little bit. Suppose you were sitting down with somebody who has, perhaps foolishly, agreed to chair the audit committee of a publicly traded company and wants a little help from you about what questions he or she should be asking to see whether the company does have a good system in place. Is it a matter of hiring the right people, and retaining the right people, or is there an inquiry an audit committee member can do to start becoming satisfied or comfortable with the control process?

**ERNEST TEN EYCK:** That's why I made the remark I did. Short of hiring somebody like Jim or I to be his eyes and ears, the continuing role that a chief internal auditor who's good, it's always a question of personnel. Somebody once said, all management problems are personnel problems, and all management solutions are personnel solutions. That to me is the end all, be all of what an audit committee is supposed to be doing, what the enormous responsibilities of Sarbanes-Oxley has put on audit committees. By having your own eyes and ears, so to speak, and a strong internal audit function that reports to the audit committee seems to me is absolutely essential.

**JAMES BARRATT:** I agree with that. Also, one of the things that some boards have done is to tie senior management's compensation to improving accounting controls and

processes. In fact, going back to my Freddie Mac example, the senior management had to agree that 25% of their bonus would be tied to improving the accounting controls in the review of the audit committee. So, that's really, I think, where you can get some traction. It's really an incentive.

**DONALD LANGEVOORT:** Is there a well accepted enough benchmark for improvement that an audit committee really knows whether management is, or is it a situation where, well, looks good, management gets the bonus.

**JAMES BARRATT:** I think that's where the difficulty is. How do you, you're obviously starting from some point, and it's a less than acceptable point, but there can be metrics along the way in terms of, for example, if say if accounts weren't being reconciled on a timely basis, or if you don't have people in the positions. If you don't have a controller that's a CPA or a CFO that's a CPA, those may be benchmarks that audit committees could use.

**ERNEST TEN EYCK:** I've seen a phenomenon the last year or so that I probably have not seen frequently enough to even recall it, which is as companies get into the 404 exercise of figuring out what their controls are and should be and documenting it and so on, I've seen a number of instances where the board has said, either the chief executive officer or the chief financial officer doesn't get it. He is incapable of taking ownership sufficient to do the certification, and he's got to go. Outside of some disaster happening, I don't ever recall seeing that in the past.

**DONALD LANGEVOORT:** That's interesting. Going back, you used the word eyes and ears, and I'd like to follow up on that a little bit. One of the criticisms implicit in 404 and all the debates is that as internal controls become more sophisticated and deeper, you're really building an internal espionage system into the corporate culture, a spy group that becomes the eyes and ears of the audit committee or somebody high up in the organization. Is that a fair comment, or something seriously worth worrying about that somehow this could be disruptive within an organization to have a separate focus of power that is supposed to be somebody's eyes and ears?

**ERNEST TEN EYCK:** I guess it's a question of the tradeoffs, and it seems to me it's worth the trade off. The Division of Enforcement at the SEC has relied on "whistleblowers" since time immemorial. Now that process has been turned internally because the whistleblower has to have, under the law, a mechanism to anonymously get that kind of whistleblowing to the audit committee. At the same time, I must tell you, it's a question of whose time gets wasted. Over the last year or so, we've seen more and more instances of disgruntled employees who are blowing the whistle on nothingness. They're blowing the whistle on supposed wrongdoing, which is just ordinary business stuff and they don't have the perspective to understand that. And somebody like Jim or I get called in or the audit committee puts a team together to go investigate it and it turns out to be a nothing. It's a molehill.

**DONALD LANGEVOORT:** But the norm is, nobody's ignoring those because you can't under this environment.

**ERNEST TEN EYCK:** Yes, and maybe it's better that the corporation spends the money than the Division of Enforcement spends the money. Generally, people would rather talk to somebody like me than the guy with badge.

**DONALD LANGEVOORT:** Right. Also going back to something you were talking about and related to this is in a sensible system, at least in the abstract, you put your eyes and ears resources where the risks are, and obviously even in the standard auditing literature, that question of risk perception has been something auditors and accountants have worried about for a long time. Talk a little bit about how auditors today in this environment look at risk. What are the kinds of risks that we've come to see as blinking that light that says let's get some forensic people in here? Have we learned much about risk perception in financial reporting?

**JAMES BARRATT:** I think in one respect the risks haven't necessarily changed. I don't know that there's new things that are coming up. We see in a lot of the SEC enforcement

actions, what have you, there's still the revenue recognition-type cases, there's the loss reserve-type cases, and so I think that depending on the business when auditors are in there, they're always going to be focusing on that. So what I've seen though, maybe a little bit more so is more an assessment of management in terms of risk where I think an auditor many times, as long as they used to have the management representation letter, where management said look, all the, everything's in order here, they felt like they were pretty well protected, but as things have unfolded and different frauds have come out, I think they step back and really take a, they look at management. That is one of the internal controls and make an independent assessment there as well.

**DONALD LANGEVOORT:** Give me examples. What does it mean to look at management? Look at their incentives? Look at their track record?

**JAMES BARRATT:** Yes, I'd say look at their integrity. Look at how they're motivated in terms of compensation. Do they have any reason to believe that they're being aggressive in some respects? Do they kind of get it when it comes to the importance and the implications of having financial statements that are properly stated?

**DONALD LANGEVOORT:** That's not an easy judgment to make. To some extent, all executives are supposed to be aggressive, especially in highly competitive industries, and I suspect don't take kindly to being told I'm a high risk item because I push my people and I push the envelope of what I'm being expected to do. Does that create tension?

**JAMES BARRATT:** You know, Ernie and I haven't audited in a long time, but I think in the course of our work, that's part of what we look at is when there's something went wrong, who was involved and why were they motivated? And what we find through just really interview probably more than anything else is getting a sense of the culture that's been created around a senior management. Are they aggressive in meetings saying we have to do whatever it takes to get this? Are they, how involved are they? Sometimes they'll be almost like an absentee management and that can lead to problems, not necessarily intentionally. So I think there's a variety of things you can look at to try to get to that answer.

**ERNEST TEN EYCK:** I think the caveat that Jim and I are from the outside looking in because we haven't been part of the auditing community for a while, the second sea change next to the audit committee, internal control, 404 thing that I've seen as a result of, partly at least from Sarbanes-Oxley is an attitude difference on the part of the auditors where there is zero tolerance for management that is even cute about what it tells the auditors, much less outright lying to them, and there is almost zero tolerance for high risk clients where many of the big firms simply will not, they just walk away from in some cases a \$2 or \$3 million engagement, that I think a few years they would have somehow managed to find a reason to keep that company as a client. So there is a big difference in the attitude and that attitude is manifesting itself in ways that I think in the long run will turn out to be positive and, by the way, make a lot of work for people like Jim and I because it is the auditors often who are going to the audit committee and saying you've got to do an independent investigation of this. You can't just blow it away because we're not going to sign off on anything until that investigation's finished, so they're becoming the drivers of bringing forensic accountants in, not as part of the audit, but as a separate term of the audit committee's own inquiries.

**DONALD LANGEVOORT:** Right. Now do you think that's going to lead to some internalization within the big auditing firms of the forensics business? Are they going to start hiring their own, or is this something that ought to be done by an independent firm? I know one of the issues posed for discussion by the AICPA is do we have an independence issue arising from greater reliance on forensics, or is this a service that is naturally part of the audit function? Do you have any thoughts about it?

**JAMES BARRATT:** Yes, a couple of thoughts there. I think that at least in the audit function as you say, there are a lot of very good auditors that are not necessarily good forensic accountants. I think there's a different kind of skill set and maybe skepticism or thinking more

like the thief that is required and it's not just a check the box kind of thing, and so there's somewhat of a transition that has been made from just pure auditor to forensic accountant. What's interesting and you raised your point is, many times an issue will come up, the auditors will look at it, it looks like there's some merit to it. Now, and that's part of what this discussion memorandum talks about is at what point should the auditors no longer pursue that and should you have an independent group or accountants like us come in and do it, we're not doing the audit, we have no interest in the outcome and I think the problem arises where if the auditors start doing that, how far can they take it down the road before they have to say sorry, management, it looks like this may end up in some type of legal proceeding. We really can't go any further, and then they've really spent a fair amount of time and effort that can't necessarily be used.

So I think that's an interesting dilemma. I think Sarbanes-Oxley kind of carved out a little bit in terms of what accountants or auditors can do and it left a little bit of the door open in terms of them continuing to do forensic accounting work, but only to a certain point, and I think that's where the profession's starting to get a little more definition maybe.

**ERNEST TEN EYCK:** I think our alma mater, the SEC, is driving that more than anything. The discussion memorandum has a lot of things that we should be thinking about talking about in terms of that issue, but the staff has taken a very dim view in most cases of the auditing firm also doing a forensic investigation per se, as opposed to a forensic specialist as a member of the audit team because they're concerned about what they perceive as objectivity if not an independence issue. If the financial statements that the firm just signed off on are in fact misstated, how can they be objective in investigating that fact. So they're driving the process and it's rare to see the auditing firm also conducting an internal accounting investigation.

**DONALD LANGEVOORT:** And there's not currently a lot of thought to in-housing a greater capacity.

**ERNEST TEN EYCK:** Well, they have the capacity. All of the major accounting firms are our competitors in that regard. It's just been separate and distinct. So you'll find Firm A coming in to assist the audit committee in doing the investigation of Firm B, and the next one you see, it'll be the other way around.

**JAMES BARRATT:** The other thing that they do, audit firms, when we come in and do internal investigations, many times they'll be kind of a shadow team if you will of forensic accountants from the auditing firm, and they're, as I understand it, basically serve as kind of a liaison between getting an assessment of what we're doing and the nature and the scope of that work, and then communicating that back to the audit team, kind of the core audit team and functioning that way. And so it's they're more kind of an adjunct to the audit team, if you will, to kind of see what the findings are in the investigation.

**DONALD LANGEVOORT:** Are you comfortable with that?

**JAMES BARRATT:** Yes, I think it's fine. It's more, I guess, comfort for the auditor signing off at the end is to get some kind of comfort, but we found many times that doesn't happen and they just have because, like the SEC views us, they have a certain amount of confidence, I guess you will, in terms of our work product and our independence, and when audit firms see that and see what we've done, they may take that and don't necessarily have to have a separate team to do it. It depends on each individual case.

**ERNEST TEN EYCK:** Well, the objective is self-reporting; that is to say, the audit committee figures it's better that they go tell the SEC that wrong was done than to have the SEC investigate it separately. That independence and objectivity is very, very important in dealing with the staff. At the same time, to go back to something we discussed earlier, it's rare for the forensic accounting team to reach any conclusions about the F-word as the SEC staff understands it. That's a conclusion that the audit committee may draw, but in my experience, you either need to have a confession from somebody who was in the loop when they fraud was perpetrated, or such overwhelming evidence, you rarely get it when conducting an investigation

without subpoena power or the ability to put people under oath, you really need to nail that down. Nine times out of ten, the SEC has to finish the job because they're the ones that come in and say raise your right hand. You're either going to take the Fifth Amendment or tell me the truth.

**DONALD LANGEVOORT:** Does that become a problem as you're succeeding in a forensic investigation and it looks like you are on to something, do you find levels of cooperation and the building of walls that essentially say you know have to go back to the audit committee or the lawyers for the company and say we've taken this about as far as we can?

**JAMES BARRATT:** Well my experience, to the extent that they're asked to cooperate, they will, and if they don't, many times that's their job and that's their choice, or they may turn to retain attorneys if they feel like they need to in the course of it, and that tends to take it to a different level. But I think when there's an internal investigation and that's important for the audit committee and management to indicate that you really need to cooperate with this, then, but I haven't faced too many non-cooperative situations.

**ERNEST TEN EYCK:** The lawyers, again we usually work for the lawyers, rare for us to be engaged by the audit committee directly along those lines, when the lawyers reach the point where they feel like they have to advise an employee that they might be best getting their own counsel, that's when you stop getting cooperation.

**DONALD LANGEVOORT:** Right. Absolutely. I want to turn to something else. You mentioned about the mindset of a forensic accountant and another one of the issues that's raised in the discussion memorandum and I guess the profession is talking about is, is this a sufficiently distinct branch of the profession that it ought to have its own educational and certification standards, and should people be trained especially as forensic accountants? And I guess I want to ask the question, how do you train somebody? What is it that you do differently to make somebody a good forensic accountant?

**ERNEST TEN EYCK:** Well mostly we have them work with other good forensic accountants. I think most of it was on the job training in my case, and I think Jim's too. A lot of it was learned at the SEC.

**JAMES BARRATT:** Yes. I think that someone had said a good forensic accountant is like a three-layered wedding cake, where the biggest piece at the bottom is kind of an accounting foundation, the second piece is more, say, an investigative, risk-management type, and then the top layer is a familiarity with legal terms and that, and then the frosting on the cake is really strong oral and written skills because you really have to combine all those things to bring it together. And there are, Ernie mentioned earlier, Certified Fraud Examiners that have cropped up and provide a lot of education in terms of how to conduct interviews, that type of thing.

**DONALD LANGEVOORT:** Explain to me what a Certified Fraud Examiner is and where that fits into the profession.

**ERNEST TEN EYCK:** Well, the Association of Certified Fraud Examiners sort of stepped into this gap, filled the evolving void close to 15 years ago now, and created the credential of CFE, the Certified Fraud Examiner, which in effect is almost a counterpart to the CPA. It says you have certain skills – you know how to interview people, you understand legal concepts, you understand how to get information from public sources, you understand how to request information from third parties – a whole set of skills. So in a way, the skill set, if not necessarily the procedures that are used, has already been defined, and I'm not sure how much of this is territorial on the part of the American Institute because they've suddenly come to the realization that there's a whole genre of us out there doing this stuff that don't have much in the way of a framework or CPA-type credentials to go with it. In fact, fraud examiners can be anybody. Many FBI agents and postal inspectors who aren't necessarily trained accountants are Certified Fraud Examiners.

**DONALD LANGEVOORT:** So it goes outside the accounting area.

**ERNEST TEN EYCK:** It goes well outside the accounting area.

**JAMES BARRATT:** There's also, as Ernie knows, there's a journal of forensic accounting which is ...

**ERNEST TEN EYCK:** Fairly new.

**JAMES BARRATT:** Yes, fairly new and kind of more academic research, but also a lot of analysis that cuts across a variety of disciplines. There's also, universities are offering majors. I think down in Florida there's a Master's in Forensic Accounting. I think it's become, what kind of evolved out of audit and law enforcement has become more of a structured kind of a skill set, but there's no substitute for on the job training, as Ernie says. Just being out there, conducting it, being there live.

**ERNEST TEN EYCK:** But I figure we came into our own when we got our own academic journal.

**DONALD LANGEVOORT:** That does seem to be.

**JAMES BARRATT:** Yes, we're legitimate now.

**DONALD LANGEVOORT:** Do you find young people wanting to become forensic financial examiners or forensic accountants as a result of the scandals the last few years? Has it gotten easier to attract people to do this kind of work?

**JAMES BARRATT:** Yes, I'd say so. I think just in terms of our shop and especially on the Freddie Mac engagement, we had folks that had some experience, but really got their feet wet and got completely soaked, and are just now very much skilled in how they view things where they weren't necessarily before. And I think that all the frauds that have been going on, there are statistics that show that enrollment for accounting programs has actually increased quite a bit, so whether that's, I'm not sure what you draw from that, but it's obviously attracted a lot of attention. I remember I used to try and explain what I did when I'd go home at night. I'm a forensic accountant and what is that? But as things started to hit the headlines and people, especially Enron I think, as they showed how things were investigated, it's become more understandable.

**ERNEST TEN EYCK:** I find we recruit a lot of people out of public accounting from the third through the seventh or eighth year of auditing, usually. I find an early sign of people who are going to be very good at it is they are very excited about how different it is to do our kind of work than to do traditional auditing work.

**DONALD LANGEVOORT:** Right. And is the SEC still a source of personnel for staff members? I would think the training there would be ...

**ERNEST TEN EYCK:** Absolutely. That's been a particular niche for us in any event, so yes, that's also particularly good training. They don't come because they find it excitingly different. They tend to come because they find it excitingly similar.

**DONALD LANGEVOORT:** And these days there's some level of excitement there. I guess one of the other issues that comes up in the discussion memorandum must be a matter that people are talking about or are interested in which is, are there liability concerns or consequences arising from the enhanced expectations? That's an issue that's been around for a long time and has to do with expectation gaps. If you are put to work on finding something and don't find it, are you worried that people have an inflated expectation and that courts may step in and say forensic accountant, you didn't do your job. You are liable under some federal or state theory of responsibility.

**ERNEST TEN EYCK:** I didn't used to worry about that, but in the last 18 months I've become aware of two instances where the SEC enforcement staff actually has a forensic accountant in its sights with respect to internal investigation work that was done working with counsel. In other words, initially at least, it was privileged. For audit committees, not in situations where, you know, the accountant is engaged in some giant cover-up of wrongdoing, but more along the lines of didn't go far enough, or didn't reach the right conclusions, and none of that thus far has resulted in any, that I'm aware of, there's never been a formal enforcement

proceeding of any kind against the forensic accountant in that role. But I'm aware of one that has proceeded to the stage of a Wells request. So it's food for thought to those who do this.

**DONALD LANGEVOORT:** Yes, it is food for thought. Do you think, I mean, the accounting profession has talked about ways to address issues like that, obviously a lot of different ones. What would you suggest? Is it a matter of realistic expectations that if people are realistic, obviously a forensic accountant can engage in fraud, but if you're realistic in your assessment of what's likely and what's possible, is that the solution, or is there something more that you would want to think about?

**JAMES BARRATT:** I think that there have been some developing standards of practice. The AICPA has put out some things. I attend a conference each year that really a collection of folks all over the country get together and talk about common issues like this, so I think it's kind of coalescing where there is some guidance, but for the most part, a lot of what we'll do is pretty much spelled out in engagement letters or statements of work and working on behalf of a law firm, you're really providing findings, not necessarily making opinions unless it goes to be expert testimony-type situation.

**ERNEST TEN EYCK:** I think there's a legal trend that certainly would enhance that risk, and that's the trend to waive privilege. As long as there's attorney-client privilege that isn't waived, and attorney work product that isn't waived, generally you're sort of shielded in many ways, at least to the extent that your client, the lawyer is shielded. Cooperation these days, I joke that it really means assume the dying cockroach position, but it definitely means on the client's part, being willing to waive the privilege and turn over documents to the government in order to be acquitted for that cooperation, and once that waiver is made, you're fair game as a forensic accountant, in terms of an investigation or otherwise.

**DONALD LANGEVOORT:** And what do you think the effect will be?

**ERNEST TEN EYCK:** I don't know. I just see it as one more thing to think about, one more reason to be extra careful about what you do.

**DONALD LANGEVOORT:** Right, and just so listeners understand, the SEC in the last year or two has become much more aggressive in its policy about charging corporations in the end unless there has been cooperation, with cooperation including a long laundry list of matters, but one of which is a positive attitude on privileges.

**ERNEST TEN EYCK:** Up to now, the only consequences of that for the forensic accountant ordinarily was a waste of time. You ended up giving away your time while the SEC took your testimony, not because they were after you, but because they wanted a brain dump from you to shortcut their investigative process. If the company is out of business, then you're not going to get paid for that. But there are some signs that it's getting to be a little closer to home than that these days.

**JAMES BARRATT:** Yes, we've seen calls for interview notes. Like I said, many times these internal investigations will end up just in an oral presentation to the audit committee or the board, then many times there'll be a report, but to get to that report, there could be interview notes or other things that in the course of doing that investigation they're trying to get to and I think that's where you could have some tightening up of standards or best practices if you will within forensic accounting.

**DONALD LANGEVOORT:** Let me come because we're almost out of time, our questioner Mike McConnell had one other he wanted to pose and it's another one of those essay questions that really goes beyond forensic accounting, but maybe because you operate out of a special niche that he might have some thoughts about. He talks about Sarbanes-Oxley and the creation of the Public Accounting Oversight Board, all of that as an evolution that's been going on for a long time. And a lot of people are asking on Capitol Hill and elsewhere, did all that corpus of regulation, does that operate as an overreaction to the scandals of the last ten years? Have we not gone far enough? I mean from the place you sit, and obviously it's a special

place, what's your reaction to how the government has reacted to the financial reporting scandals of the couple of years? Big question.

**JAMES BARRATT:** Yes, I'll take the first stab and then Ernie can finish. I think that in some ways it's been good, and in some ways it's been bad, and yet it's a little bit too early to tell how it's ultimately going to end up. I think the emphasis on management through certifications or otherwise on making sure that financial statements are fairly presented, that they have controls, is a good thing, and I think that all the developments before that were always trying to lead towards that. You need to have good tone at the top. The downside, I think there's been a tremendous cost to businesses to implement some of these things, like 404, and who knows where that's going to come out, but there's a significant cost of doing business that's then added to that.

**ERNEST TEN EYCK:** I agree with Jim that it remains to be seen whether the benefits and the costs are going set off each other, and for small companies the costs are just enormous. I'm working with one company that's spending more on 404 than its revenues, literally. 10K revenues, but that's the way it's working out. The one positive thing that I've seen is that chief executive officers in particular are paying attention to these things, to a degree I don't think I've ever seen in the past. It was the rare chief executive officer who took a personal interest in whether or not his internal controls are working properly. The prospect of having to sign that certification when the next 10K gets filed has really gotten their attention and I think that's a positive.

**DONALD LANGEVOORT:** We'll really, I guess have to see what the enforcement posture is. We have a lot of rules on the books that have made people very nervous, but not a real round of SEC enforcement of these new standards, and I guess it's there that you'll learn how serious this really is.

**ERNEST TEN EYCK:** Plus, you've got, and I haven't seen it yet that I'm aware of, but there's a spiral consequence where internal controls were always under 13B and early case law said no private right of action. Now you have a certification to it which they can prove the certification was false.

**DONALD LANGEVOORT:** So we'll see.

**ERNEST TEN EYCK:** We will see indeed.

**DONALD LANGEVOORT:** Well thank you for coming today and having this discussion on forensic accounting. Thanks also to FTI Consulting, Inc for making today's chat possible. A reminder again, today's chat is now archived in the Society's virtual museum, so you can listen again to the discussion or read the discussion later on. And next time, our Fireside Chat will focus on business recovery requirements for clearance and settlement organization in light of September 11<sup>th</sup> with Donald Donahue and Richard Nesson of The Depository Trust and Clearing Corporation. Join us on Thursday, November 11<sup>th</sup> at 2PM, Eastern Standard Time. Thanks for being with us.

**ERNEST TEN EYCK:** Thank you for having us.