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How do CPA Firms Approach Forensic Accounting

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NORTHERN ILLINOIS UNIVERSITY

How do CPA Firms Approach Forensic Accounting

A Thesis Submitted to the

University Honors Program

In Partial Fulfillment of the

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Department of Accountancy

By Vicki Mudro

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ABSTRACT (100-200 WORDS):

This paper examines how Certified Public Accounting (CPA) firms approach forensic accounting in their organizational structure and hiring practices. Its purpose is to find how and why external auditors form fraud divisions and what credentials are needed to work in this field. It studies the fraud auditing or forensic accounting divisions within the Big Five accounting firms KPMG, Arthur Andersen, Deloitte & Touche, PriceWaterhouseCoopers, and Ernst & Young.

This paper provides those interested in the field of fraud and public accounting an overview of how the organizations incorporate fraud divisions within their regular external auditing practice. Further, it provides insight as to the types of skills, experience, and other qualifications that are necessary to work in this field of accounting. The research conclusions are limited to the Big Five fraud audit or forensic accounting divisions as this group of five firms is unique to the public accounting industry and are not always representative of all public accounting firms. In addition, the method of interviewing representatives of the firm also limits the paper, as interviewees may try to present facts with the most positive interpretation.

The research was conducted through reviews of the five firm's websites to obtain facts and information about the firm's practice and by interviews with representatives of the firm's fraud divisions. Overall, the five public accounting firms studied KPMG, Arthur Andersen, Deloitte & Touche, Ernst & Young, and PriceWaterhouseCoopers approach forensic accounting very similarly. These firms all set up fraud divisions separate from their fundamental audit practices and used the same advancement levels of staff, senior, manager, and partner within the divisions to determine the extent of work performed by an individual. The skills needed to practice in the fraud divisions were similar to that of the external audit practices with additional skills of thinking like a criminal and evaluating people and their emotions needed to be the most successful in these divisions. Certifications such as CPA and Certified Fraud Examiner (CFE) were found to be necessary as an individual advances into higher levels of the division.

I. Introduction

The number of new financial statement fraud cases cited by the SEC has more than doubled in the past six years. The annual cost of employee fraud in the United States is up to \$400 billion or 6% of corporate revenues (Bishop). Fraud is obviously a growing problem worldwide. Many people have insistently asked why the issue cannot be solved and why auditors are not finding fraud before it becomes such a large problem. The problem really lies in that auditors are constantly challenged to distinguish between intentional financial statement misstatements and unintentional errors, when they both have the same effect on the financial statements. As the problem continues to grow many public accounting firms have responded to this issue by forming fraud auditing practices and forensic or investigative accounting practices as divisions within its firms. Many people however do not understand the role these divisions play in fraud discovery, what skills or certifications are needed for this type of job, nor how this type of division functions within a public accounting firm or with clients. In realizing the variety of opportunities that exist in fraud auditing and forensic accounting this paper investigates the area of fraud investigation. My basic research focuses on how Certified Public Accounting (CPA) firms approach fraud auditing or forensic accounting in their organizational structure and hiring practices.

This research began by reviewing books in order to obtain a solid foundation of fraud and all of its aspects. Different public accounting firms websites were reviewed to select firms for this study and to obtain information for the research. Through this process KPMG, Deloitte & Touche, Arthur Andersen, Ernst & Young, and PriceWaterhouseCoopers were selected as firms that provided large investigative

practices in the area of fraud auditing and investigation. I conducted interviews with the different firms by contacting partners in fraud divisions to obtain information on each firm's practice. After interviews and website searches were finished I compiled all of my information into the paper.

The research indicates that the five firms have very similar practices including setup in the organization, types of work performed, and skills and certifications required to be in this type of division. They usually obtain clients through contacts from the victim's attorney and they usually go into the situation when the fraud is already known or suspected to collect specific evidence and to piece everything together for a prosecuting case. All of the firms have setup divisions separate from its independent audit function, and does not function as a team on any regular independent audits. Furthermore, all of the firms prefer to have people with strong backgrounds in accounting with a special interest in the area of fraud. As these people advance in the division, certifications such as CPA, Certified Fraud Examiner (CFE), and other experiences are required. This paper investigates these and many other different aspects of the firm's divisions.

This paper is setup as follows: Part II discusses the background information regarding the public accountant's responsibility for detecting fraud and forensic accounting; Part III discusses the methodology that I used to approach answering my research question; Part IV discusses the results of my research; Part V is my summary of my research and conclusions about the research.

II. Background Material

Fraud is a very broad legal concept. There are many different perceptions of what constitutes fraud and different environments for it to occur. Generally, fraud consists of intentionally making material misrepresentations of fact, with the intent of inducing someone to believe it and act upon it and, thus suffer a loss or damage (Louwers & Robertson, 1999). People commit fraud in a variety of ways including embezzlement, larceny, employee fraud, misappropriation of assets, and fraudulent financial reporting to name a few. Fraud has become a worldwide epidemic harming some of the worlds largest and even smallest companies. In May 1998 and yet again in 2000, Ernst and Young LLP conducted a worldwide survey concluding that over 50% of the participating companies had been defrauded in some way in the last ten years and 30% had experienced more than five frauds within the last five years (Ernst & Young, 2000). Further, employees committed 84% of the worst frauds experienced by these companies (Fraud and Management Accountants, 1999). These studies alone give way to the importance of dealing with this issue. However, fraud cases such as Pharmor, ZZZZ Best Co., Crazy Eddie Inc., the Savings and Loan scandals, and many others that have been exposed to the public have really lead to such a large concern for the issue, especially concerning public accountants and their responsibility for it.

CPAs have always been responsible for maintaining the integrity and reliability of recorded transactions through audit procedures. These audit procedures are very detailed and have provided the public with assurance that a company's financial reports are materially correct so that investors and creditors can use this information to make informed business decisions. A CPA's responsibility for correctness of financial statements has ultimately led to the public believing they have a responsibility for fraud

detection as well. The auditors have been seen as the ultimate line of defense against fraud in the organizations, but cases like the ones mentioned above lead to questions concerning the auditor's ability to handle this type of responsibility. Over the years critics have debated over defining the external auditor's or CPA's responsibility for detecting fraud in the organizations they audit. The public, the Securities and Exchange Commission (SEC), investors, creditors, and many others have all tried to have CPA's responsibility for this redefined to meet their different needs and expectations.

The first attempt to define the auditor's responsibility for fraud detection was started in 1978 with the Cohen commission. Appointed by the American Institute of Certified Public Accountants (AICPA), the Cohen commission's purpose was to define and recommend the appropriate responsibilities of independent auditors, as well as to find and explore the expectation gap between what the public expects and what auditors reasonably accomplish. The Cohen commission published a report in 1978 that defined a number of ideas that CPA's still adhere to today (Coggins, 2000). The issues discussed in this report were the independent auditor's role in society; forming an opinion on financial presentations; reporting on significant uncertainties in financial presentations; responsibility for detection of fraud; corporate responsibility and the law; auditor's communication with users; education, training, and development of auditors; the independence of the auditors and how to maintain it; establishment of audit standards; and regulation of the profession to achieve a standard of quality in audit practice (Coggins, 2000).

In addition, this commission also determined that an expectation gap existed between the auditor's and the users of financial statements. This gap really defined why the public

is in such heated controversy over the issue of fraud. Basically, the users of financial statements, i.e. investors, creditors, and the public, misunderstand the role of the auditors and the nature of the service they offer. Users generally believe that one of the CPA's audit's main objectives is fraud detection; thus many users believe that the auditors in their audit procedures would find *all* errors and occurrences of fraud (Coggins, 2000). Yet, even today auditors have really only taken the responsibility for the detection of *material* misstatements in financial statements caused by errors or frauds. Thus, the auditors were taking responsibility for verifying financial statement balances with a range of acceptance for mistakes. They were not taking responsibility to investigate all matters that contributed to the balances, but a random selection of the items that would provide reasonable assurance that the balances were materially correct so they could provide an opinion as to the organization's financial situation (Louwers & Robertson, 1999).

In 1987, the American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), Institute of Management Accountants (IMA), and the Financial Executives Institute (FEI) sponsored the Treadway commission to further deal with the situation of fraud. The commission's sole purpose was to determine the factors contributing to fraudulent financial reporting, to develop practical recommendations to reduce the incidence of this problem, and to further try and lessen the public's misunderstanding of the auditor's role. The committee placed responsibility for the accuracy of financial statements in the hands of the entity's management, as well as gave management the responsibility to set a tone of personal and professional ethics within the company. Further, the committee stressed the need for enhancing internal controls (Coggins, 2000).

In response to both the Cohen and Treadway commissions the AICPA issued new standards for independent auditors to practice by, which not only further defined the auditor's responsibility but also gave a better understanding of their responsibility for fraud detection. The new standards issued in 1988 and 1989 were SAS 53 to SAS 65. Of the most important standards related to the issue of fraud were SAS 53 and SAS 54. SAS 53 discussed the auditor's responsibility to detect and report errors and irregularities, and SAS 54 discussed illegal acts by clients and the auditor's responsibility for identifying the situation and reporting it appropriately (Coggins, 2000). SAS 82 then later amended SAS 53 in 1997 when the accounting profession was being attacked for variety of public scandals where they had not detected management fraud. SAS 82 provided a clear statement that the auditors are responsible for fraudulent acts that cause a misstatement of financial statements including misstatements from fraudulent financial reporting and misstatements from misappropriation of assets. SAS 54 was also later amended with the 1995 Reform act that gave auditors the responsibility to detect illegal acts and related transactions in public companies. Also, it makes the auditor responsible to report the issues to the Board of Directors of the company and the Audit Committee, who then have one day to report the problem to the SEC. If this report is not filed within the given day, the independent auditor is responsible by law to report it to the SEC so that matters could be handled appropriately. Overall, these statements changed the way certified public accountants viewed and approached their audit procedures (Coggins, 2000).

Auditors are now "required to understand fraud, assess fraud risks, design audits to provide reasonable assurance of detecting material management and employee fraud that could have a material effect on financial statements, and report findings to management,

directors, sometimes users of financial statements, and under certain conditions outside agencies” (Louwers & Robertson, 1999). External auditors use materiality thresholds and sampling confidence levels to assess the assurance of the financial statement balances. Further, the external auditors also make considerations regarding the size of the fraud as well as who is committing the fraud. Some frauds may be inconsequential and need only be reported to management above the people involved. However, fraud involving senior management and those causing material misstatements in the financial statements are then reported directly to the organization’s audit committee of the board of directors. These standards of practice are common among all public accounting firms and define the auditor’s role in a variety of ways (Louwers & Robertson, 2000).

Today many people are still debating whether CPAs have really taken enough responsibility for fraud detection. There is still criticism of the public accounting profession for its lack of integrity in taking more responsibility for fraud. Auditors are still seen as somewhat of an ultimate defense against fraud. Many experts claim that the reason for this misconception is due to the complexity and technical nature of the standards (Bishop, 2000). Still others claim that auditor’s are not trained in the areas, including criminal law, needed to detect well-executed frauds (Bologna & Lindquist, 1995). Building a case for prosecution of fraud is very difficult and takes more attention to detail and process of obtaining evidence that even the greatest auditor would have trouble at perfecting without the proper training. In response to this problem, many new areas of accounting have come into existence.

First practiced by the FBI in federal cases and then in the mid to late 1980’s by smaller firms, forensic accounting and fraud auditing are becoming well known in the

accounting industry with the increasing occurrence of fraud in organizations. We now have the Association of Certified Fraud Examiners that numbers over 20,000 and is still growing. Large CPA firms have also taken a step in helping to combat the problem by providing a separate division within its consulting practices dedicated to forensic accounting, fraud auditing, or litigation support. Fraud auditors are accountants who by virtue of their attitudes, attributes, skills, knowledge, and experience, are experts in detecting and documenting frauds in books of account. Forensic accountants on the other hand are called in after evidence or suspicion of fraud has surfaced through allegation, complaint or discovery (Bologna & Lindquist, 1995). Litigation support encompasses them all in that its purpose is to use accounting and criminology knowledge to detect and prosecute white-collar criminals.

Fraud groups in public accounting firms have also caused some controversy as to why they are needed if the independent auditors should be detecting fraud that is materially important. The groups have also created debate as to the service they really provide and how independent they really are from their audit practice as a whole. The public has a widespread misunderstanding of what these groups entail, their purpose in public accounting firms, and how they function within a public accounting firm.

III. Methodology

To conduct this research on public accounting firm's fraud auditing, forensic accounting, or litigation support practices I began by reviewing textbooks on auditing and fraud (Louwers & Robertson, 2000; Albrecht, 1997). The readings provided a background in the area of fraud and helped gain an understanding of the auditor's responsibility for fraud detection. In addition, I reviewed the different public accounting

firm's websites to see which firms offered these types of services and to find contacts within these divisions. I narrowed my search to the Big Five public accounting firms, as these were the firms with the largest fraud audit or forensic practices. These firms were easily studied because of divisions with the sole function of fraud auditing or forensic accounting. These firms are as follows: Arthur Andersen, Deloitte&Touche, Ernst&Young, KPMG, and PriceWaterhouseCoopers. By searching their websites I gained insight into each firm's organizational structure, the divisions functions, and the different offerings these divisions provided clients. I was also able to obtain information regarding skills, certifications, experience, and the basic makeup of the different firm's practices.

I formulated a set of questions to ask based on the information about their firm and the background information I reviewed (see appendix) to help conduct the interviews. Next, I contacted the public accounting firms via e-mail and phone to set interview times or other arrangements. Following this, I contacted the firms at the decided times and used my scripted interview questions to lead the discussion concerning their firm's practice. I asked the interviewees all of the questions on the script, providing examples and clarity as needed. In addition, I asked other questions pertinent to each individual conversation with the division's firm representative to elicit the most detailed and informative answers possible. For each interview, I manually recorded their answers to the questions when using the phone interview method. When using e-mail, I printed their answers to the script questions and corresponded with them later to obtain additional or more detailed information.

IV. Research Results

Fraud Divisions-General Information

In researching the KPMG, D&T, E&Y, PWC, and AA, I found that the firms offer very similar services for their clients in the area of forensic and litigation services. All of the firms researched have a separate division of investigative services from their independent audit practice that provides these services that work independently from the external audit. The firm's reasons for offering these types of services to their clients as a separate service were:

- Strong market need for fraud detection services because the government has so many cases of fraud with high dollar requirements for prosecution that many get left undiscovered or further investigated
- External audit only deals with material frauds in relation to the overall financial statement picture, which is harder to elicit detail of frauds if not found in samplings.
- Their experience, education, expertise, training, and knowledge all help to increase the likelihood that they could provide a valued service as client's needs in this area are growing.

Services offered in the fraud investigation area of these firms include investigation of suspected transaction frauds by employees, corporate financial statement frauds by management, asset recovery and analysis investigations, insurance claims frauds, expert testimony, and regulated entities such as the health care industry. The main objectives of these divisions are to go in after there are suspicions of fraud occurrence and determine:

- How the fraud occurred
- Who was involved

- What the extent of the losses were
- How the fraud was perpetuated and concealed
- How fraud can be prevented from recurring.

These divisions were not involved in uncovering fraud where it was unknown to have occurred or no suspicions exist.

To obtain clients the public accounting firm's fraud divisions were usually contacted by the victim company's attorneys to investigate a suspected fraud. Partners that work on the victim's audit engagement also refer client's attorneys to these public accounting fraud divisions. How far the fraud investigators go in the investigation and what they do with the results is all a matter of whether the matter will be prosecuted by the victim company or not. If the client wants prosecution, after the fraud evidence is gathered and assimilated into a case the team hands it over to the FBI or SEC. If there is no prosecution then the team gives the results to the company to do with it what they may, but all firms encourage prosecution.

Despite current beliefs that such a division does not have the established independence to be objective in finding fraud for audit clients, many interviewees said that this is not an issue. The divisions work separate from each other. Further, because the division is hired by the client's attorney to investigate a fraud, whether the client is their firm's or another firm's is immaterial. Many interviewees said that the concern about how your firm's external audit team will look is non-existent. In regards to performing their work, these forensic divisions are basically a separate entity from the external auditors, so that no matter who the client might be, objectivity is always present. If the investigation concerns a firm's clients, the team of external auditors does have to

report the fraud to the audit committee of the board of directors who have one day to notify the SEC if the company is publicly held. If notification does not occur, then the external auditor is required to report it for the company.

Skills, Certifications, Experience...

Most firms agree that the basic skills required to be a financial statement auditor help to be successful in this field. In addition to the regular skills and knowledge required to be a financial statement auditor, forensic accountants or fraud auditors have some additional attributes that help to make them more successful in finding frauds. These skill sets and attributes provide the forensic accountant with a strong foundation to go in and detect frauds, its causes, and its prevention. The chart shown below lists the skills required to be a financial statement auditor and the additional skills needed to be a successful forensic accountant or fraud auditor.

Chart 1

General Audit Skills	Additional Forensic Skills
* Good accounting education	*Openness
* CPA certification	*Curious
*Analytical Skills	*Inquisitive
*Ambition	*Persistence
*Hard work ethic	*Skeptical
*Tact in all situations	*Detail-Oriented
*Quick learning	*Understanding people
*Quick thinking	*Behavioral Interviewing
*Strong computer skills	*Evaluating integrity
*Good client service attitude	*Good communication skills
*Honesty	*Dealing well with people's emotions
*Objectivity	* Thinking like a thief
*Independent	*Creative
	*Good research skills
	*Spontaneous

These skill sets help someone to be very proficient in the task of forensic accounting but there are other necessary requirements to be successful in this arena. As part of the nature of the job certain education requirements are needed. Forensic accounting divisions within these public accounting firms usually require that a candidate have an undergraduate degree in accounting as well as a CPA certification. Some candidates who have had valid, extensive prior experience with law enforcement backgrounds, such as those in the FBI may not have this but are trained very intensively on technical accounting matters. In addition to the CPA certification, a CFE certification, although not required initially, is strongly encouraged if a candidate would like to remain in the forensic division to become a partner.

Experience is another key variable in determining a candidate's success in the forensic or fraud divisions of the public accounting firms. All said that at the entry level, required experience would be minimal and that the most important thing was academic interest in that area and strong accounting background. To be a senior or a manager it was necessary to have experience in audit and some investigation. Many FBI agents in the area of fraud investigations go to public accounting firms or investigative firms to continue their practice after their years are done with the government.

Level of Responsibility

In relation to the structure of the division different responsibilities exist as a person moves up the ladder into partner. The levels of advancement are similar to that of an independent auditor in the regular financial statement assurance practice, with the difference being in the work performed. As a staff person in the investigative divisions the work would focus on examining accounting records, analyzing, summarizing, and

limited interviewing of victim's employees. After 2 years in this position the candidate moves into being a senior and still continues to analyze and summarize accounting records by doing the more difficult work and supervising the day-to-day operations. Then 2 to 3 years after spending time as a senior the candidate moves into the manager position where they are responsible for conducting interviews of all suspects and other people with information, obtaining clients, and supervising the work. Finally after another 5 to 7 years as a manager a candidate then can become a partner, and as such is responsible for finding clients, reviewing the investigation procedures for risk and completeness, and interviewing the most senior executives in the company.

All firms have these levels of advancement with the work in the different levels varying very little. Variances in this area are in the length that each person stays in each position. This usually depends on skills, quick learning, and showing proficiency, knowledge, and expertise. The greater these variables the faster someone would advance in the division. One important thing to note here is that those with significant investigative experience, such as in the FBI can and usually transfers in at manager levels depending on breadth and depth of experience.

V. Conclusions

Overall, the five public accounting firms studied KPMG, Arthur Andersen, Deloitte & Touche, Ernst & Young, and PriceWaterhouseCoopers approach forensic accounting very similarly. The skills, certifications, attributes, and experience required by all firms to be in this division is basically very similar to that of what the firms require of their independent auditors and usually goes beyond that. The organizational setup for

the divisions was also very similar in that they all setup separate divisions independent of the main independent audit practice.

It is very interesting to note that most of the firms go in as forensic accountants to piece together known or suspected frauds rather than going into the company to find unknown or unsuspected frauds. Partially I believe the reason for this is in that the latter type of work is a bigger responsibility to take on because it assumes that you will find all frauds. This increases the potential for litigation. Other reasons might include that a service like this would be too costly for the client and lack of fraudulent resources including investigators. The latter problem is very large despite the variety of services out there because fraud is such a widespread plague. I also found it very interesting that most of these divisions obtain clients by having attorneys of the victim company contact them instead of avidly pursuing cases that their own firm independent audits. Conflicts of interest is a very important issue, yet most firms indicated that this is not a concern because they work for the lawyer and conduct the investigations without regard for how it might make the independent auditors look. Concerns as to the relative objectivity of these divisions in auditing their firm's work may still exist to a degree despite these claims.

These research conclusions are all based on the Big Five that limits the extent to which these conclusions and findings apply to smaller public accounting firms or other similar entities. The Big Five are entities that represent only themselves in operations, organization, and qualifications. Smaller firms in the fraud audit or forensic accounting practice such as Meaden & Moore may or may not vary in a variety of ways from this study. One suggestion would be to see how these smaller firm's fraud services compare

to Big Five. Further limitations existed in this study based on the sole nature of obtaining the information through interviews. Interviewees are subjective and are likely to give a more positive interpretation of their work and their firm. Also, certain limitations exist due to the interviewer placing a more positive light on the subject and trying to avoid controversy to obtain information.

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Appendix

Scripted Interview Questions:

1. Why does your firm offer the service of a Fraud and Forensic group to its clients?
2. How does offering this service affect the firm's external auditing function?
3. Describe your group's main function and how it serves the client?
4. What responsibility to the client to find fraud do you external auditors have?
5. Does this affect your division's work?
6. Does the suspect have to be already known in the cases you work on?
7. How far does your firm go in the investigation? (i.e. to whom and when do you turn over evidence)
8. Does your firm form teams with people from your group and external auditors when doing an audit?
9. What is the basic structure of the firm and how does your division fit into it?
10. How does your division obtain clients? (i.e. lawyer referrals, current audit clients)
11. What is the structure of your division so far as advancement levels (staff, seniors, partners, etc.)?
12. What are the different responsibilities at each level in your division?
13. What skills do you look for in your division's new hires, and are these skills similar to those for the assurance practice?
14. What prior experience should new hires to this division have at the different levels?
15. Do many people who are in your group transfer from the external audit/assurance division or do you hire for your group mainly from the outside?
16. Currently what is the makeup of the firm's group, so far as members in it and their certifications, experience, etc.?