

# Contents

## **PART ONE**

### **INTRODUCTION TO FORENSIC ACCOUNTING AND FRAUD EXAMINATION 1**

#### **Chapter 1**

#### **Introduction to Forensic Accounting and Fraud Examination 3**

- Forensic Accounting and Fraud Examination 3
- The Forensic Accountant and Fraud Examiners 5
  - Knowledge and Skills of the Forensic Accountant and Fraud Examiner 6*
- Opportunities in Forensic Accounting and Fraud Examination 7
- Professional Organizations 9
- Organization of This Book 10
- Summary 10
- Glossary 11
- Review Questions 11

#### **Chapter 2**

#### **The Forensic Accounting Legal Environment 15**

- Roadmap to the Legal System 15
- Civil and Criminal Procedures 16
  - The Legal System and Jurisdiction 16*
  - Investigations and Trials 20*
- Common-Law Crimes 31
  - Larceny 31*
  - Burglary 31*
  - Conspiracy 32*
  - Embezzlement 32*
  - Fraud (False Pretense) 32*
  - Robbery 33*
  - Extortion 33*
  - Arson 33*
  - Solicitation 33*
  - Aiding and Abetting 33*
- Federal Financial Crimes: The United States Code and Acts of Congress 33
  - 18 U.S.C 96: Racketeer Influenced and Corrupt Organizations Act (RICO) 34*
  - 15 U.S.C 78dd: Foreign Corrupt Practices Act (FCPA) of 1977 34*

- The Sarbanes-Oxley (SOX) Act of 2002 34*
- Federal Computer Intrusions Laws 35*

- Summary 37
- Glossary 38
- Review Questions 41
- Discussion Questions 43
- Bill of Rights 46

#### **Chapter 3**

#### **Fundamentals I: Accounting Information Systems 47**

- Business and Internal Control Processes 47
  - The Internal Control Process 50*
  - Components of Internal Control Processes 53*
- Transaction Processing Controls 58
  - General Controls 58*
  - Application Controls 58*
  - Application of Internal Control Principles to the Basic Transaction Cycles 59*
  - Examples of Internal Control Problems 67*
- Systems Development 69
- Summary 70
- Glossary 71
- Review Questions 73
- Discussion Questions 76
- Cases 77

#### **Chapter 4**

#### **Fundamentals II: The Auditing Environment 81**

- Auditing 82
- Demand for Auditing 82
- Licensing 83
- Rule-Making Bodies 83
- International Boards That Affect the Accounting Profession 84
- Generally Accepted Auditing Standards 85
- The Audit 86
- Materiality and Risk 86
  - Materiality 86*
  - Risk 88*
- Audit Reports 90
  - Standard Unqualified Report 90*
  - Unqualified Report with Modified Wording 92*
  - Qualified Report 94*

x Contents

*Adverse Report* 95  
*Disclaimer Report* 95  
Audit Assertions 96  
*Presentation and Disclosure* 96  
*Rights and Obligations* 96  
*Existence or Occurrence* 96  
*Completeness* 97  
*Valuation or Allocation* 97  
Evidence-Gathering Procedures 98  
*Confirmation* 98  
*Observation* 99  
*Physical Examination* 99  
*Reperformance* 99  
*Analytical Procedures* 99  
*Inquiry of the Client* 100  
*Documentation* 100  
Types of Tests 101  
*Tests of Controls* 101  
*Substantive Tests of Transactions* 101  
*Analytical Procedures* 102  
*Substantive Tests of Balances* 103  
Sampling 103  
*Sampling Risk* 104  
*Sampling for Attributes* 104  
*Sampling for Substantive Tests of Balances* 105  
The Audit Process 107  
*Plan and Design the Audit* 107  
*Performance of Tests of Controls and Substantive Tests of Transactions* 108  
*Performance of Analytical Procedures and Substantive Tests of Balances* 108  
*Completion of the Audit and Issuance of the Audit Report* 108  
The Audit of Internal Controls over Financial Reporting 109  
*Design Deficiencies* 109  
*Auditor's Evaluation Process* 110  
*Reporting on Internal Control over Financial Reporting* 110  
The Auditor's Responsibility to Detect Fraud 111  
*SAS No. 99, Consideration of Fraud in a Financial Statement Audit* 111  
*Financial Fraud* 112  
*The Profession's Response to Fraud* 112  
Other Services 112  
*Reports on Specified Elements, Accounts, or Items on Financial Statements* 113  
*Agreed-Upon Procedures Engagements* 113  
*Compliance Reports* 113  
*Review* 113  
*Prospective Financial Statements* 114

*Specialty Assurance Services* 114  
*Compilation* 115  
Other Auditing Functions 116  
*Internal Auditing* 116  
*Operational Auditing* 116  
*Governmental Auditing* 117  
Summary 118  
Glossary 119  
Review Questions 121  
Discussion Questions 125  
Cases 126

**PART TWO**  
**FRAUD EXAMINATION THEORY,**  
**PRACTICE, AND METHODS 129**

**Chapter 5**  
**Fraud Prevention and Risk**  
**Management 131**

Fraud Prevention and Information Security Management System (ISMS) 131  
*Key Concepts in ISMS* 133  
International Standards Organization Series 27000 Relating to Information Security 134  
*ISO 27001: Implementing ISMSs* 135  
*PDCA Reports and the ISMS Deliverable* 140  
*ISO 27002: Code of Security Practices* 140  
IT Security Assurance 141  
*How Assurance Is Achieved* 141  
*Forms of Assurance* 142  
*Assurance Authorities* 144  
*Assurance Methods and Approaches* 144  
*Well-Known Information Security Assurance Methods and Their Primary Assessment Properties* 145  
Applied Security Controls 151  
*ISO/IEC 27002 Areas Applied to ISMSs* 151  
Summary 155  
Glossary 157  
Review Questions 160  
Discussion Questions 163  
Cases 164

**Chapter 6**  
**Fraud Detection 167**

Ways in Which Occupational Fraud Is Discovered 167  
*Fraud Discovery from Tips and Hotlines* 167  
*Fraud Discovery by Accident* 169

<i>Fraud Discovery by Financial Statement Auditors</i>	169
<i>Fraud Discovery by Internal Auditors</i>	170
<i>Fraud Discovery by Inspectors General</i>	170
<i>Fraud Discovery by Security Departments</i>	171
<b>Fraud Detection and Enterprise Risk Management</b>	171
<i>Importance of Detection Relative to Prevention and Correction</i>	171
<i>Fraud versus Errors, Waste, and Inefficiency</i>	173
<i>Optimal Design of Fraud Detection Systems</i>	174
<i>Relative Cost of Detection versus Prevention and Correction</i>	175
<i>Alternative Cost Scenarios</i>	178
<i>Definition of the Fraud Indicator</i>	179
<i>Obtainment of Cost Estimates</i>	180
<b>Data-Driven Fraud Detection</b>	180
<i>Sources of Data</i>	180
<i>Data-Driven Fraud Detection Applications and Tools</i>	182
<i>Data-Driven Applications for Small Businesses</i>	183
<i>Ad Hoc Fraud Detection Tools</i>	183
<b>Steps in Building a Fraud Detection System</b>	184
Summary	187
Glossary	188
Review Questions	189
Discussion Questions	191
Cases	192

## **Chapter 7**

### **The Fraud Investigation and Engagement Processes 195**

<b>The Fraud Investigation Process</b>	196
<i>The Engagement Process</i>	196
<i>The Evidence Collection Process</i>	196
<i>The Reporting Process</i>	197
<i>The Loss Recovery Process</i>	197
<b>The Fraud Engagement Process</b>	197
<i>Create the Incident Report and the Case File</i>	199
<i>Conduct the Initial Notifications and Evaluation</i>	200
<i>Consider Legal Issues</i>	201
<i>Evaluate Loss Mitigation and Recovery</i>	
<i>Considerations</i>	202
<i>Determine the Objectives, Scope, and Costs of the Investigation</i>	205
<i>Create the Engagement Letter or Memorandum</i>	208
Summary	210
Glossary	212
Review Questions	213
Discussion Questions	215
Cases	217

## **Chapter 8**

### **The Evidence Collection Process 223**

<b>Introduction</b>	223
<i>Embezzlement Case Example</i>	223
<i>The Investigator's Role in Building a Case</i>	225
<b>The Evidence Collection Process</b>	226
<i>Types of Evidence</i>	226
<i>The Steps in the Evidence Collection Process</i>	227
<i>Interviews</i>	228
<i>The Order of Interviews</i>	230
<b>Application of the Fraud Theory Approach to Guide the Evidence-Gathering Process</b>	230
<i>The Fraud Theory Approach</i>	230
<i>The Fraud Theory Approach to Fraud Investigation</i>	232
Summary	236
Glossary	238
Review Questions	239
Discussion Questions	242
Cases	243

## **Chapter 9**

### **Fraud Examination Evidence I: Physical, Documentary, and Observational Evidence 247**

<b>Introduction</b>	247
<b>Physical Evidence</b>	248
<b>Documents and Records</b>	249
<b>Sources of Documentary Evidence</b>	250
<i>Personnel Files</i>	250
<i>Résumes</i>	250
<i>Current Co-Workers</i>	251
<i>Friends and Acquaintances</i>	251
<i>Postemployment Background Checks</i>	251
<i>Sites Other Than the Suspect's Home State</i>	251
<i>Social Networking Sites</i>	251
<i>Records Available to the Public</i>	251
<i>Restricted Records</i>	253
<i>Methods for Obtaining Restricted Records</i>	255
<i>Link Analysis</i>	256
<b>Analytical Procedures and Audit Techniques</b>	256
<i>Analytical Procedures</i>	256
<b>Questioned Document Analysis</b>	265
<i>Questioned Documents</i>	265
<b>Observational Evidence</b>	267
<b>Choice of the Appropriate Evidence-Gathering Technique</b>	270
Summary	272
Glossary	274

Appendix: Common Analytical Procedures 275  
Review Questions 278  
Discussion Questions 281  
Cases 282

## Chapter 10

### Fraud Examination Evidence II: Interview and Interrogation Methods 285

Introduction 286  
The Interviewing Process 286  
    *Preparing for the Interview* 286  
    *Conducting Multiple Interviews* 288  
    *Conducting the Individual Interview* 288  
    *Using Interview Techniques* 299  
Signed Confession and Release of Information 308  
Summary 310  
Glossary 312  
Review Questions 313  
Discussion Questions 317  
Cases 317

## Chapter 11

### Fraud Examination Evidence III: Forensic Science and Computer Forensics 325

Forensic Science 325  
    *Participants in Forensic Science Investigations* 325  
    *Types of Evidence Used in Court* 329  
    *Testimonial Evidence* 334  
    *Investigatory Tools in Forensic Science* 335  
Computer Forensics 335  
    *Essential Considerations in Computer Forensic  
    Investigations* 336  
    *Steps in Forensic Investigation of Computers* 338  
Law Enforcement Databases and Networks 345  
    *Automated Fingerprint Identification System (IAFIS)* 345  
    *National DNA Index System (NDIS)* 345  
    *Combined DNA Index System (CODIS)* 345  
    *National Integrated Ballistics Information Network  
    (NIBIN)* 345  
    *National Law Enforcement Telecommunications Systems  
    (NLETS)* 345  
    *National Crime Information Center (NCIC)  
    Network* 345  
    *Financial Crimes Enforcement Network  
    (FinCEN)* 346  
Summary 346  
Glossary 347  
Review Questions 349

Discussion Questions 352  
Cases 353

## Chapter 12

### The Fraud Report, Litigation, and the Recovery Process 355

Fraud Investigation Reports 355  
    *Uses of Fraud Investigation Reports* 355  
    *Elements of a Fraud Report* 359  
    *The Investigator's Liability in Writing a Fraud  
    Investigation Report* 360  
Fraud Loss Recovery 361  
    *Accept the Fraud Loss* 361  
    *Collect Insurance* 361  
    *Litigate* 363  
Expert Testimony 364  
    *Expert Consultants and Discovery* 364  
    *Expert Witnesses* 365  
    *Pretrial Issues for Expert Witnesses* 369  
    *Trial Tactics and Principles Concerning Experts* 371  
    *Professional and Ethics Guidelines for Expert  
    Witnesses* 372  
    *Legal Liability of Expert Witnesses* 372  
Summary 372  
Glossary 376  
Review Questions 376  
Discussion Questions 379  
Cases 380

## PART THREE

### OCCUPATIONAL AND ORGANIZATIONAL FRAUD 383

## Chapter 13

### Employee, Vendor, and Other Frauds against the Organization 385

The Fraud Problem in Perspective 385  
    *People Who Commit Fraud against the  
    Organization* 387  
    *Employee Fraud and Corporate Culture* 389  
Employee Fraud Schemes 390  
    *Revenue Cycle Fraud* 390  
    *Accounts Receivable Fraud* 392  
    *Expenditure Cycle Fraud* 394  
    *Production Cycle Fraud* 395  
    *Other Types of Employee Fraud* 396  
The Audit Processes in Detecting and Preventing  
Employee Fraud 396

<i>Audit Trail</i>	396
<i>Internal Audit</i>	397
<i>Physical Security and Monitoring</i>	397
<i>Fraud Reporting Hotlines, Training, and Education</i>	397
Vendor Fraud	397
Frauds from Customers and Competitors	397
Employee Fraud Methods in Electronic Accounting Information Systems	398
<i>Input Manipulation</i>	398
<i>Direct File Alteration</i>	399
<i>Program Alteration</i>	399
<i>Data Theft</i>	400
<i>Sabotage</i>	400
Summary	400
Glossary	402
Review Questions	403
Discussion Questions	406
Cases	407

## Chapter 14

### Financial Statement Fraud 411

Introduction to Financial Statement Fraud	411
<i>Financial Statement Fraud Schemes</i>	412
<i>Characteristics of Financial Statement Fraud</i>	414
<i>Motives for Management to Commit Financial Statement Fraud</i>	415
<i>Bad News/Good News Example</i>	416
<i>Fraud-Created Insider Information Period</i>	417
<i>Effects of Financial Statement Fraud on Company and Management</i>	418
Financial Statement Fraud, the Stock Market, and Insider Trading	418
Prevention of Financial Statement Fraud	419
<i>Sarbanes-Oxley Act</i>	419
<i>Red Flags: Indications of Possible Financial Statement Fraud</i>	421
Management Discretion, Earnings Management, and Earnings Manipulation	423
<i>Management Discretion</i>	423
Cases of Financial Statement Fraud and Manipulation	428
<i>McKesson &amp; Robbins: Financial Statement Fraud 101</i>	428
<i>The Great Salad Oil Swindle</i>	428
<i>Equity Funding: They Made a Movie About It</i>	428
<i>Cedant Corporation: Manufacturing Revenues</i>	428
<i>Zzzz Best: The Teenager Who Fooled Wall Street</i>	428
<i>Sunbeam Corp.: Channel Stuffing</i>	429
<i>Nortel: The Ultimate Big Bath</i>	429

<i>WorldCom: Boosting Earnings in a Big Way</i>	429
<i>Enron: Lessons in Creative Accounting</i>	429
<i>Qwest and Global Crossing: Swap Sales</i>	430
Summary	430
Glossary	431
Review Questions	432
Discussion Questions	435
Cases	436

## Chapter 15

### Fraud and SOX Compliance 439

Introduction	439
Overview, Enforcement, and Rules and Regulations	440
<i>The SEC and the Sarbanes-Oxley Act</i>	441
The Sarbanes-Oxley Act	442
<i>Title 1—Public Company Accounting Oversight Board</i>	443
<i>Title 2—Auditor Independence</i>	444
<i>Title 3—Corporate Responsibility</i>	445
<i>Title 4—Enhanced Financial Disclosures</i>	446
<i>Title 5—Analyst Conflicts of Interest</i>	447
<i>Titles 6 and 7—Commission Resources and Authority and Studies and Reports</i>	447
<i>Title 8—Corporate and Criminal Fraud Accountability</i>	447
<i>Title 9—White-Collar Crime Penalty Enhancements</i>	448
<i>Title 10—Corporate Tax Returns</i>	448
<i>Title 11—Corporate Fraud and Accountability</i>	448
<i>SOX Rules, Regulations, and Standards</i>	448
Sarbanes-Oxley Compliance	449
<i>The Federal Criminal Sentencing Guidelines</i>	449
<i>The COSO Reports</i>	452
<i>The COBIT Standard</i>	453
<i>ISO 27002</i>	455
<i>Comparison of the Various Models for Control Practices</i>	456
SOX 404 Compliance with Small Public Companies	456
<i>Special Characteristics of Small Public Companies</i>	456
<i>How Small Public Companies Can Compensate for Their Size</i>	457
<i>How Small Public Companies Can Achieve Efficiency in Internal Control Processes</i>	458
Summary	458
Glossary	459
Review Questions	460
Discussion Questions	462
Cases	464

## **PART FOUR SPECIALIZED FRAUD AREAS 467**

### **Chapter 16**

#### **Tax Fraud 469**

- Overview of Tax Fraud 469
- Tax Practitioners and the IRS 470
  - Tax Practitioners* 470
  - The IRS* 471
- Types of Taxes and the Internal Revenue Code 472
  - Individual Income Tax* 472
  - Corporate Income Tax* 472
  - Sales and Use Taxes* 473
  - Employment Taxes* 473
  - Other Taxes* 474
  - The Internal Revenue Code* 474
- Principal Tax Evasion Crimes 475
  - Willful Attempt to Evade or Defeat the Imposition of Tax* 475
  - Interference with Tax Laws* 482
  - Forcible Rescue of Seized Property* 482
  - Termination and Jeopardy Assessments of Income Tax* 483
  - Related Title 18 Offenses* 483
- Civil Tax Fraud 485
  - Nonfraudulent Errors and Behavior* 485
  - Civil Fraud Indicia and Evidence* 485
  - Civil Fraud and Other Penalties* 486
- Statute of Limitations 488
  - Criminal Tax Prosecutions* 488
  - Assessment and Collection of Tax* 489
  - Liens and Seizures* 489
- Methods of Proof 491
  - Direct Method* 491
  - Indirect Methods* 492
- Tax Protesters 499
  - Categories of Tax Protester Arguments* 499
- Summary 501
- Glossary 502
- Review Questions 504
- Discussion Questions 507
- Cases 508

### **Chapter 17**

#### **Bankruptcy, Divorce, and Identity Theft 511**

- Bankruptcy Fraud 511
  - Bankruptcy Fraud Penalties* 512
  - Frequent Bankruptcy Frauds* 513
  - Bankruptcy Procedures* 514
  - Discovery of Fraud, Abuse, and Concealed Assets* 517

- Bankruptcy Fraud Cases* 521
- Divorce Fraud 522
  - Discovery in Divorce Cases* 522
  - Identification of Concealed Assets in Divorce Cases* 522
- Identity Theft 522
  - Federal Laws Relating to Identity Theft* 524
  - Terrorism, Identity Theft, and False Identification* 528
  - Identify Theft Prevention* 528
  - Warning Signs of Identity Theft* 530
  - Identity Theft Investigation* 530
  - Identity Theft and Related Crimes* 531
  - Damage Control* 531
- Summary 531
- Glossary 533
- Review Questions 534
- Discussion Questions 537
- Cases 538

### **Chapter 18**

#### **Organized Crime, Counterterrorism, and Anti-money Laundering 541**

- Organized Crime 542
  - International Crime-Fighting Efforts* 542
  - La Cosa Nostra* 543
  - Legal Investigations and LCN* 548
  - Eurasian Organized Crime* 548
- Terrorism 553
  - Islamic Background and Influence* 553
  - The European Legal System and Terrorists* 555
  - The European Terrorist Profile* 556
  - Operation of Terrorist Cells* 557
  - Usama bin Laden and the Globalization of Jihad* 558
- Money Laundering 559
  - The Three-Step Money-Laundering Process* 560
  - Anti-money Laundering Organizations and Laws* 565
- Glossary 571
- Review Questions 575
- Discussion Questions 578
- Cases 579

## **PART FIVE**

### **OTHER FORENSIC ACCOUNTING SERVICES 583**

#### **Chapter 19**

#### **Business Valuation 585**

- Financial Asset Valuation 585
- Relevant Professional Organizations 587

<i>Standards Promulgators</i>	587
<i>Professional Organizations and Designations</i>	588
Basic Valuation Theory	590
<i>Standard of Value</i>	590
<i>Valuation Premises</i>	592
<i>Valuation Approaches</i>	595
<i>Valuation Adjustments</i>	597
<i>Valuation Estimates</i>	598
The Process of Valuing a Business	598
<i>Define the Valuation Assignment</i>	599
<i>Collect and Analyze Information About the Business</i>	599
<i>Research the Industry in Which the Business Operates</i>	600
<i>Study and Analyze the Business's Financial Statements</i>	600
<i>Select and Apply Valuation Methods and Approaches to Produce a Valuation Estimate</i>	602
<i>Produce a Final Valuation Estimate</i>	602
<i>Issue the Valuation Report</i>	602
Valuation Methods	603
<i>Valuation Methods Associated with the Income Approach</i>	603
<i>Valuation Methods Associated with the Market Value Approach</i>	608
<i>Valuation Methods Associated with the Asset-Based Approach</i>	610

Summary	611
Glossary	612
Review Questions	615
Discussion Questions	619
Cases	619

## **Chapter 20**

### **Dispute Resolution Services 623**

Introduction	623
Alternative Dispute Resolution	625
<i>Arbitration</i>	626
<i>Mediation</i>	627
<i>Nontraditional ADR Techniques</i>	628
Applications of Alternative Dispute Resolution	629
<i>Labor Interest Arbitration</i>	629
Corporate ADR Programs	631
<i>Steps in Setting up a Corporate ADR Program</i>	631
Summary	633
Glossary	635
Review Questions	636
Discussion Questions	637
Case	638

## **Index 639**