

Fraud Examination

Prevention, Detection, and Investigation

3rd Edition

Steven M. Bragg

Table of Contents

Chapter 1 – Introduction to Fraud.....	1
Learning Objectives	1
Introduction.....	1
What is Fraud?.....	1
Confidence	1
The Effects of Fraud.....	2
Fraud Triggers	2
Perceived Pressure	3
Opportunity.....	4
Rationalization	5
Fraud Addiction.....	5
Collusion.....	5
Types of People More Likely to Engage in Fraud.....	6
Types of Fraud.....	6
Financial Statement Fraud.....	6
Embezzlement.....	6
Supplier Fraud.....	7
Customer Fraud.....	7
Investment Scams	7
Common Fraud Risk Indicators	8
Responsibility for Fraud Prevention.....	9
The Fraud Examiner	10
Summary	10
Review Questions	11
Review Answers	12
Chapter 2 – Fraud and Theft Schemes	13
Learning Objectives	13
Introduction.....	13
Cash Theft.....	13
Disbursement-Related Theft.....	14
False Expense Reports.....	14
Misuse of Company Credit Card	15
Billings from Fake Suppliers.....	15
Self-Insurance Fraud	16
Unauthorized Shipments.....	16
Redirected Payments	16
Check Theft.....	16
ACH Debits	17
Compensation Fraud	17
Executive Loans	17
Workers' Compensation Fraud.....	17
Workers' Fraud.....	17
Check Kiting.....	17
Solicitations Disguised as Invoices	18
Lapping.....	18
Inventory Theft.....	19
Product Replacement Fraud.....	19
Fixed Asset Theft and Misuse	20
Bust-Out Scams.....	20
Advance-Fee Loan Schemes	20
Kickbacks	21
Bid Rigging	21
Bribery	21

Table of Contents

Conflicts of Interest	22
Insider Trading	22
Stock Option Backdating	22
Information Theft	23
Time Theft	23
Money-Laundering Schemes	24
Nominee Schemes	25
Business Cover Schemes	25
Cashier's Check Schemes	26
Asset Purchase Schemes	26
Financial Statement Fraud Schemes	26
Sales Inflation	27
Expenses Falsification	28
Marketable Securities Falsification	29
Prepaid Expenses Falsification	29
Receivables Falsification	29
Loss Reserves Falsification	30
Inventory Falsification	30
Fixed Asset Falsification	31
Liability Falsification	32
Debt Falsification	33
Discontinued Operations Stuffing	34
Cash Flow Reclassifications	34
Acquisition Falsification	35
The Most Difficult Financial Statement Fraud Areas to Detect	36
Financial Statement Disclosure Fraud	36
Fraud Schemes More Common in Closely Held Businesses	37
Summary	38
Review Questions	39
Review Answers	40
Chapter 3 – Financial Statement Fraud	41
Learning Objectives	41
Introduction	41
Reasons for Financial Statement Fraud	41
Instigators	42
How Financial Statement Fraud Begins	42
The Financial Statements	43
The Balance Sheet	43
The Income Statement	45
The Statement of Cash Flows	47
Interactions between the Financial Statements	49
Horizontal Analysis	49
Vertical Analysis	50
Interrelationships Analysis	52
Revenue Interrelationships	52
Revenue Acceleration Interrelationships	54
Cost of Goods Sold Interrelationships	54
Capitalization Interrelationships	55
Ratio Analysis	55
Financial to Non-financial Relationships	56
Time-Based Analysis	57
Other Red Flags	57
A Note of Caution	60
The Auditor's Approach	61
Other Factors to Consider	62
The Management Team	62

Table of Contents

The Organizational Structure	62
The Size of the Organization.....	62
The Board of Directors.....	62
The Auditors.....	63
Legal Issues	63
Short Selling.....	63
Related Entities	63
Footnotes	63
Industry Analysis	64
Summary	64
Review Questions	65
Review Answers	66
Chapter 4 – Fraud Prevention	67
Learning Objectives	67
Introduction	67
Combatting Perceived Pressure	67
Minimizing Fraud Opportunities	67
Cultural Adjustment Activities	68
Hire Correctly	68
Communicate Expectations	70
Provide an Example.....	71
Establish the Work Environment	71
Handle Fraud Situations Correctly.....	72
Minimizing Collusion	73
Engaging in Fraud Auditing Activities	73
Combatting Rationalization.....	73
Fraud Prevention for the Small Company	73
Fraud Prevention for Outsiders.....	74
Summary	74
Review Questions	75
Review Answers	76
Chapter 5 – Fraud Policies and Controls.....	77
Learning Objectives	77
Introduction	77
Policies	77
Audit Policy	77
Check Signing Policy	77
Employee Background Check Policy.....	77
Employee Bonding Policy	78
Expense Receipt Policy	78
Expense Review Policy.....	78
Employee Transfer Policy	78
Missing Check Policy.....	78
Stock Sale Investigations.....	78
Supplier Background Check Policy	78
Vacation Policy.....	78
Whistleblower Rewards Policy	79
Control Activities	79
Segregation of Duties	79
Authorization Levels	79
Independent Reviews	80
Physical Safeguards	80
Documentation	80
Preventive and Detective Controls.....	80
Manual and Automated Controls	81

Table of Contents

When to Add Controls	81
Control Overrides.....	82
Fraud-Specific Order Entry Controls.....	82
Fraud-Specific Credit Controls.....	83
Fraud-Specific Shipping Controls	83
Fraud-Specific Billing Controls.....	84
Fraud-Specific Cash Controls.....	84
Fraud-Specific Inventory Controls.....	86
Fraud-Specific Fixed Asset Controls.....	86
Fraud-Specific Payable Controls	87
Fraud-Related Purchasing Controls.....	90
Fraud-Related Receiving Controls.....	91
Fraud-Related Payroll Controls	91
Fraud-Specific Journal Entry Controls	93
General Controls.....	93
Oversight Capabilities	93
Incentive Systems.....	94
Small Business Controls	94
Summary	95
Review Questions	96
Review Answers	97
 Chapter 6 – Fraud Detection	 99
Learning Objectives	99
Introduction.....	99
Fraud Symptoms.....	99
Accounting Anomalies	99
Analytical Anomalies.....	101
Lifestyle Symptoms.....	102
Unusual Behavior	103
Assistance in Spotting Fraud.....	103
Assistance from Employees.....	103
The Employee Hotline	104
Assistance from Suppliers and Customers.....	104
Assistance from Auditors	104
Records Examination	105
Publishing Activities	105
Data Analysis.....	105
Data Analysis Techniques	106
Benford's Law.....	107
Cross-Matching Analysis	108
Outlier Analysis.....	109
Trend Analysis.....	109
Discovery Sampling	110
Access to Documents	110
Nonfraud Factors	111
Where Fraud Does Not Occur	111
Undetectable Fraud.....	112
Role of the Auditor in Fraud Detection	112
Summary	113
Review Questions	114
Review Answers	115
 Chapter 7 – Fraud Investigation.....	 117
Learning Objectives	117
Introduction.....	117
Whether to Investigate	117

Table of Contents

Investigation Policies and Procedures	117
Fraud Investigative Techniques	118
Documentary Evidence	119
Personal Observation.....	119
Physical Evidence	120
Testimonial Evidence	121
Invigilation.....	121
The Need for Objectivity.....	121
The Need for Investigation Secrecy.....	122
Involving the Police	122
Signed Confessions	122
Summary	122
Review Questions	123
Review Answers	124
Chapter 8 – Investigation of Concealment and Conversion.....	125
Learning Objectives	125
Introduction	125
The Chain of Custody	125
Organizing the Evidence	125
Document Examination	126
Conversion and Incarceration Information Sources.....	126
National Crime Information Center	126
Interstate Identification Index	127
Federal Inmate Database	127
Tax Returns.....	127
State-Level Information.....	127
County-Level Information.....	128
Divorce Information.....	128
Probate Court Information.....	128
Professional Licensing Information.....	128
Rental Information	128
SEC Filings	129
Tax Assessor Information	129
Title Information.....	129
Voter Registration Information.....	129
Acquaintances Information.....	130
Trash Analysis.....	130
Fee-based Search Tools	130
Investigations Related to Mail Fraud.....	130
Calculating the Amount Stolen	130
Summary	131
Review Questions	132
Review Answers	133
Chapter 9 – Fraud Interviewing Techniques.....	135
Learning Objectives	135
Introduction	135
The Ideal Interviewer.....	135
Types of Interviewees	136
The Ideal Interview.....	136
Interview Planning.....	136
The Interview	137
Interactions with Friendly Interviewees.....	137
Interactions with Unfriendly Interviewees	139
Asking for an Admission of Guilt	140
Additional Interviewing Rules	144

Table of Contents

Activities Following the Interview.....	144
Income Questions	145
Lifestyle Questions.....	145
Interviewee Motivations.....	145
Reactions to Fraud.....	145
Integrity Testing	146
Summary	146
Review Questions	147
Review Answers	148
Chapter 10 – The Fraud Report.....	149
Learning Objectives	149
Introduction.....	149
Report Tone.....	149
Sample Text of the Report.....	149
Summary	155
Review Questions	156
Review Answers	157
Chapter 11 – Legal Aspects of Fraud	159
Learning Objectives	159
Introduction.....	159
Types of Prosecution	159
The Civil Litigation Process	160
The Criminal Litigation Process	160
The Fraud Examiner Role in Lawsuits	161
Federal Statutes Covering Fraudulent Activities	161
17 CFR 240.10b5-1 – Trading “on the basis of” Material Nonpublic Information.....	162
15 U.S. Code § 78dd-1 – Prohibited Foreign Trade Practices.....	162
18 U.S. Code § 201 – Bribery of Public Officials and Witnesses.....	162
18 U.S. Code § 500 – Money Orders	162
18 U.S. Code § 1030 – Fraud and Related Activity in Connection with Computers	162
18 U.S. Code § 1037 – Fraud and Related Activity in Connection with Electronic Mail.....	162
18 U.S. Code § 1341 – Frauds and Swindles.....	162
18 U.S. Code § 1342 – Fictitious Name or Address.....	163
18 U.S. Code § 1344 – Bank Fraud	163
18 U.S. Code § 1956 – Laundering of Monetary Instruments.....	163
18 U.S. Code § 1961 – Racketeer Influenced and Corrupt Organizations.....	163
26 U.S. Code § 7201 – Attempt to Evade or Defeat Tax	163
41 U.S. Code § 8701 – Prohibited Conduct (Kickbacks)	163
Summary	163
Review Questions	164
Review Answers	165
Glossary.....	167
Index	171