

Principles of Fraud Examination

4th Edition

Joseph T. Wells

Table of Contents

Chapter 1 – Introduction	1
Learning Objectives	1
Introduction.....	1
Fraud Examination Methodology.....	2
Predication.....	2
Fraud Theory Approach	2
Tools Used in Fraud Examinations.....	4
Defining Occupational Fraud and Abuse	5
Defining Fraud.....	5
Defining Abuse	7
Research in Occupational Fraud and Abuse	9
Edwin H. Sutherland	9
Donald R. Cressey	9
Dr. W. Steve Albrecht	17
Richard C. Hollinger.....	20
<i>The 2012 Report to the Nations on Occupational Fraud and Abuse</i>	26
Detecting and Preventing Occupational Fraud.....	37
Summary.....	39
Review Questions.....	40
Review Answers	42
 Chapter 2 – Skimming	 46
Learning Objectives	46
Case Study.....	46
Overview	49
Skimming Data from the ACFE 2011 <i>Global Fraud Survey</i>	49
Skimming Schemes	50
Sales Skimming	50
Receivables Skimming.....	57
Proactive Computer Audit Tests Detecting Skimming.....	63
Summary.....	66
Review Questions.....	67
Review Answers	68
 Chapter 3 – Cash Larceny.....	 71
Learning Objectives	71
Case Study	71
Overview	73
Cash Larceny Data from the ACFE 2011 <i>Global Fraud Survey</i>	74
Cash Larceny Schemes	74
Larceny at the Point of Sale	74
Larceny of Receivables.....	77
Cash Larceny from the Deposit.....	78
Proactive Computer Audit Tests for Detecting Cash Larceny.....	82
Summary.....	84
Review Questions.....	85
Review Answers	86
 Chapter 4 – Billing Schemes.....	 88
Learning Objectives	88
Case Study	88
Overview	90

Table of Contents

Billing Scheme Data from the ACFE 2011 <i>Global Fraud Survey</i>	91
Billing Schemes	92
Billing Schemes Involving Nonaccomplice Vendors.....	98
Pay-and-Return Schemes	98
Overbilling with a Nonaccomplice Vendor's Invoices	99
Preventing and Detecting Fraudulent Invoices from a Nonaccomplice Vendor.....	102
Personal Purchases with Company Funds	102
Personal Purchases through False Invoicing.....	103
Personal Purchases on Credit Cards or Other Company Accounts.....	106
Preventing and Detecting Personal Purchases on Company Credit Cards and Purchasing Cards	107
Proactive Computer Audit Tests for Detecting Billing Schemes	107
Summary.....	110
Review Questions.....	111
Review Answers	113
Chapter 5 – Check Tampering.....	117
Learning Objectives	117
Case Study	117
Overview	119
Check Tampering Data from the ACFE 2011 <i>Global Fraud Survey</i>	119
Check Tampering Schemes	119
Forged Maker Schemes.....	120
Forged Endorsement Schemes.....	125
Altered Payee Schemes.....	129
Concealed Check Schemes	132
Authorized Maker Schemes	134
Concealing Check Tampering	136
The Fraudster Reconciling the Bank Statement.....	137
Re-Altering Checks	140
Falsifying the Disbursements Journal	140
Reissuing Intercepted Checks.....	141
Bogus Supporting Documents.....	141
Electronic Payment Tampering	141
Prevention and Detection	142
Proactive Computer Audit Tests for Detecting Check Tampering Schemes	143
Summary.....	145
Review Questions.....	146
Review Answers	148
Chapter 6 – Payroll Schemes.....	152
Learning Objectives	152
Case Study	152
Overview	154
Payroll Scheme Data from the ACFE 2011 <i>Global Fraud Survey</i>	154
Payroll Schemes.....	154
Ghost Employees	155
Falsified Hours and Salary	159
Commission Schemes	163
Proactive Computer Audit Tests for Detecting Payroll Fraud.....	167
Summary.....	171
Review Questions.....	172
Review Answers	173

Table of Contents

Chapter 7 – Expense Reimbursement Schemes	176
Learning Objectives	176
Case Study	176
Overview	178
Expense Reimbursement Data from the ACFE 2011 <i>Global Fraud Survey</i>	178
Expense Reimbursement Schemes	178
Mischaracterized Expense Reimbursements	179
Preventing and Detecting Mischaracterized Expense Reimbursements	181
Overstated Expense Reimbursements	181
Fictitious Expense Reimbursement Schemes	183
Multiple Reimbursement Schemes	185
Proactive Computer Audit Tests for Detecting Expense Reimbursement Schemes.....	189
Summary	189
Review Questions	190
Review Answers	191
Chapter 8 – Register Disbursement Schemes	194
Learning Objectives	194
Case Study	194
Overview	196
Register Disbursement Data from the ACFE 2011 <i>Global Fraud Survey</i>	196
Register Disbursement Schemes	196
False Refunds	197
False Voids	201
Concealing Register Disbursements	203
Small Disbursements	203
Destroying Records	204
Preventing and Detecting Register Disbursement Schemes	204
Proactive Computer Audit Tests for Detecting Register Disbursement Schemes	204
Summary	206
Review Questions	207
Review Answers	208
Chapter 9 – Noncash Assets	210
Learning Objectives	210
Case Study	210
Overview	212
Noncash Misappropriation Data from the ACFE 2011 <i>Global Fraud Survey</i>	212
Noncash Misappropriation Schemes	214
Misuse of Noncash Assets	214
Unconcealed Larceny Schemes	215
Asset Requisitions and Transfers	218
Purchasing and Receiving Schemes	219
False Shipments of Inventory and Other Assets	220
Other Schemes	224
Concealing Inventory Shrinkage	225
Altered Inventory Records	225
Fictitious Sales and Accounts Receivable	225
Write Off Inventory and Other Assets	226
Physical Padding	226
Preventing and Detecting Thefts of Noncash Tangible Assets that are Concealed by Fraudulent Support	226
Misappropriation of Intangible Assets	227
Misappropriation of Information	227
Misappropriation of Securities	227

Table of Contents

Proactive Computer Audit Tests for Detecting Noncash Misappropriations	228
Summary	230
Review Questions	231
Review Answers	233
Chapter 10 –Corruption.....	237
Learning Objectives	237
Case Study	237
Overview	239
Corruption Data from the ACFE 2011 <i>Global Fraud Survey</i>	239
Corruption Schemes	240
Bribery	241
Kickback Schemes.....	242
Overbilling Schemes	242
Bid-Rigging Schemes	246
Something of Value.....	251
Illegal Gratuities	252
Economic Extortion	252
Conflicts of Interest	252
Purchasing Schemes	255
Sales Schemes.....	257
Other Conflict of Interest Schemes	258
Preventing and Detecting Conflicts of Interest	259
Anti-Corruption Legislation.....	259
Foreign Corrupt Practices Act	259
The United Kingdom Bribery Act	261
Proactive Computer Audit Tests for Detecting Corruption.....	262
Summary	265
Review Questions	266
Review Answers	268
Chapter 11 – Accounting Principles and Fraud	271
Learning Objectives	271
Fraud in Financial Statements.....	271
Who Commits Financial Statement Fraud?	271
Why Do People Commit Financial Statement Fraud?	271
How Do People Commit Financial Statement Fraud?	272
Conceptual Framework for Financial Reporting	273
Economic Entity	274
Going Concern	274
Monetary Unit	275
Periodicity	275
Historical Cost	275
Revenue Recognition	275
Matching	275
Full Disclosure	275
Cost-Benefit	275
Materiality	276
Industry Practice	276
Conservatism	276
Relevance and Reliability	276
Comparability and Consistency	276
Responsibility for Financial Statements	277
Users of Financial Statements	277
Types of Financial Statements	278

Table of Contents

The Sarbanes–Oxley Act of 2002.....	279
Public Company Accounting Oversight Board	283
Certification Obligations for CEOs and CFOs	284
Standards for Audit Committee Independence	285
Standards for Auditor Independence	286
Enhanced Financial Disclosure Requirements.....	287
Protections for Corporate Whistleblowers under Sarbanes–Oxley	288
Enhanced Penalties for White-Collar Crime.....	289
Financial Statement Fraud Data from the ACFE Global Fraud Survey	290
Frequency and Cost.....	290
Types of Financial Statement Fraud Schemes	290
Summary.....	291
Review Questions.....	292
Review Answers	294
Chapter 12 – Financial Statement Fraud Schemes	298
Learning Objectives	298
Case Study	298
Overview	302
Defining Financial Statement Fraud	302
Costs of Financial Statement Fraud	303
Fictitious Revenues	304
Sales with Conditions.....	306
Pressures to Boost Revenues	306
Red Flags Associated with Fictitious Revenues.....	307
Timing Differences.....	307
Matching Revenues with Expenses.....	307
Premature Revenue Recognition.....	308
Long-Term Contracts	309
Channel Stuffing	310
Recording Expenses in the Wrong Period	310
Red Flags Associated with Timing Differences	311
Concealed Liabilities and Expenses	312
Liability/Expense Omissions.....	312
Capitalized Expenses	313
Expensing Capital Expenditures.....	314
Returns and Allowances and Warranties	314
Red Flags Associated with Concealed Liabilities and Expenses	315
Improper Disclosures	315
Liability Omissions	315
Subsequent Events.....	315
Management Fraud.....	316
Related-Party Transactions.....	316
Accounting Changes	317
Red Flags Associated with Improper Disclosures	317
Improper Asset Valuation.....	317
Inventory Valuation	318
Accounts Receivable	319
Business Combinations.....	319
Fixed Assets	319
Red Flags Associated with Improper Asset Valuation	322
Detection of Fraudulent Financial Statement Schemes.....	322
AU 240—Consideration of Fraud in a Financial Statement Audit	322
Financial Statement Analysis	328
Interpretation of Financial Ratios.....	331

Table of Contents

Deterrence of Financial Statement Fraud	333
Reduce Pressures to Commit Financial Statement Fraud.....	334
Reduce the Opportunity to Commit Financial Statement Fraud.....	334
Reduce Rationalization of Financial Statement Fraud.....	334
Summary	337
Review Questions.....	339
Review Answers	342
Chapter 13 – External Fraud Schemes	346
Learning Objectives	346
Case Study	346
Overview	348
Threats from Customers	348
Check Fraud	348
Credit Card Fraud	349
Threats from Vendors	350
How Prevalent Is Vendor Fraud?.....	351
Collusion among Contractors	351
Contract Performance Schemes	351
Preventing and Detecting Vendor Fraud.....	352
Threats from Unrelated Third Parties	353
Computer Fraud.....	353
Corporate Espionage	355
Why Do Companies Resort to Corporate Espionage?	356
Favorite Targets of Corporate Espionage	356
How Spies Obtain Information.....	357
Preventing and Detecting Corporate Espionage	357
Summary	358
Review Questions.....	359
Review Answers	360
Chapter 14 – Fraud Risk Assessment	362
Learning Objectives	362
Introduction.....	362
Overview	362
What Is Fraud Risk?	362
Why Should an Organization Be Concerned about Fraud Risk?	362
Factors That Influence Fraud Risk.....	362
What is a Fraud Risk Assessment?.....	363
What Is the Objective of a Fraud Risk Assessment?.....	363
Why Should Organizations Conduct Fraud Risk Assessments?	363
Improve Communication and Awareness about Fraud.....	364
Identify What Activities Are the Most Vulnerable to Fraud.....	364
Know Who Puts the Organization at the Greatest Risk	364
Develop Plans to Mitigate Fraud Risk.....	364
Develop Techniques to Determine Whether Fraud Has Occurred in High-Risk Areas	364
Assess Internal Controls	364
Comply with Regulations and Professional Standards	364
What Makes a Good Fraud Risk Assessment?.....	365
Collaborative Effort of Management and Auditors.....	365
The Right Sponsor	365
Independence and Objectivity of the People Leading and Conducting the Work	365
A Good Working Knowledge of the Business.....	366
Access to People at All Levels of the Organization	366
Engendered Trust	366

Table of Contents

The Ability to Think the Unthinkable	366
A Plan to Keep It Alive and Relevant.....	366
Considerations for Developing an Effective Fraud Risk Assessment.....	367
Packaging It Right.....	367
One Size Does Not Fit All.....	367
Keeping It Simple.....	367
Preparing the Company for the Fraud Risk Assessment.....	367
Assembling the Right Team to Lead and Conduct the Fraud Risk Assessment.....	367
Determining the Best Techniques to Use in Conducting the Fraud Risk Assessment.....	368
Obtaining the Sponsor's Agreement on the Work to Be Performed.....	369
Educating the Organization and Openly Promoting the Process	369
Executing the Fraud Risk Assessment.....	369
Identifying Potential Inherent Fraud Risks	370
Assessing the Likelihood of Occurrence of the Identified Fraud Risks.....	371
Assessing the Significance to the Organization of the Fraud Risks	372
Evaluating Which People and Departments Are Most Likely to Commit Fraud and Identifying the Methods They Are Likely to Use	372
Identifying and Mapping Existing Preventive and Detective Controls to the Relevant Fraud Risks	372
Evaluating Whether the Identified Controls Are Operating Effectively and Efficiently.....	373
Identifying and Evaluating Residual Fraud Risks Resulting from Ineffective or Nonexistent Controls	373
Addressing the Identified Fraud Risks	373
Establishing an Acceptable Level of Risk	373
Ranking and Prioritizing Risks.....	373
Responding to Residual Fraud Risks.....	375
Reporting the Results of the Fraud Risk Assessment	375
Considerations When Reporting the Assessment Results	375
Making an Impact with the Fraud Risk Assessment.....	376
Beginning a Dialogue across the Company	376
Looking for Fraud in High-Risk Areas	376
Holding Responsible Parties Accountable for Progress	376
Keeping the Assessment Alive and Relevant.....	376
Monitor Key Controls	377
The Fraud Risk Assessment and the Audit Process	377
Fraud Risk Assessment Tool.....	377
Summary.....	377
Review Questions.....	379
Review Answers	380
Chapter 15 – Conducting Investigations and Writing Reports	382
Learning Objectives	382
Introduction.....	382
When is an Investigation Necessary?.....	382
Planning the Investigation.....	383
Selecting the Investigation Team.....	383
Developing Evidence	384
Covert Operations.....	385
Surveillance.....	385
Informants	386
“Dumpster-Diving”	386
Subpoenas	386
Search Warrants.....	386
Voluntary Consent	386

Table of Contents

Preserving Documentary Evidence	386
Chain of Custody	387
Preserving the Document.....	387
Organizing Documentary Evidence	387
Chronologies	388
To-Do Lists	388
Using Computer Software to Organize Documents and Other Data.....	388
Sources of Information.....	388
In-House Sources	388
Public Information	389
Report Writing.....	395
Purpose of the Report.....	395
Know the Reader	395
Format.....	396
Opinions or Conclusions in Report	400
Summary	400
Review Questions.....	401
Review Answers	402
Chapter 16 – Interviewing Witnesses	403
Learning Objectives	403
Introduction.....	403
Introductory Questions	403
General Rules for the Introductory Phase of the Interview	404
Informational Questions	405
Closing Questions.....	408
Assessment Questions	408
Verbal Clues to Deception.....	409
Nonverbal Clues	410
Typical Attitudes Displayed by Respondents	411
Admission-Seeking Questions.....	413
Steps in the Admission-Seeking Interview	414
Summary.....	422
Review Questions.....	423
Review Answers	424
Chapter 17 – Occupational Fraud and Abuse: The Big Picture.....	426
Learning Objectives	426
Introduction.....	426
Defining Abusive Conduct	426
Measuring the Level of Occupational Fraud and Abuse.....	427
The Human Factor	427
Understanding Fraud Deterrence	429
The Impact of Controls.....	429
The Perception of Detection.....	429
The Corporate Sentencing Guidelines.....	431
Definition of Corporate Sentencing.....	431
Vicarious or Imputed Liability	432
Requirements	432
The Ethical Connection.....	432
Concluding Thoughts	434
Summary.....	435
Review Questions.....	436
Review Answers	437

Table of Contents

Appendix A: Online Sources of Information	439
Appendix B: Sample Code of Business Ethics and Conduct.....	447
Appendix C: Risk Assessment Tool.....	459
Glossary.....	485
Index	495