

# **Fraud Examination**

---

Prevention, Detection, and Investigation

4<sup>th</sup> Edition

Steven M. Bragg

# Table of Contents

---

<b>Chapter 1 – Introduction to Fraud.....</b>	<b>1</b>
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
<b>Chapter 2 – Fraud and Theft Schemes .....</b>	<b>13</b>
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
<b>Chapter 3 – Financial Statement Fraud .....</b>	<b>41</b>
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
<b>Chapter 4 – Fraud Prevention .....</b>	<b>67</b>
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
<b>Chapter 5 – Fraud Policies and Controls.....</b>	<b>77</b>
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
<b>Chapter 6 – Fraud Detection .....</b>	<b>99</b>
Learning Objectives .....	99
Introduction.....	99
Fraud Symptoms.....	99
Accounting Anomalies .....	99
Analytical Anomalies.....	101
Lifestyle Symptoms .....	103
Subcontractor Anomalies.....	103
Unusual Behavior .....	105
Assistance in Spotting Fraud .....	105
Assistance from Employees.....	105
The Employee Hotline .....	106
Assistance from Suppliers and Customers.....	106
Assistance from Auditors .....	106
Records Examination .....	107
Publishing Activities .....	107
Data Analysis.....	107
Data Analysis Techniques .....	108
Benford's Law.....	108
Cross-Matching Analysis .....	110
Outlier Analysis .....	111
Trend Analysis.....	111
Discovery Sampling .....	112
Access to Documents .....	112
Nonfraud Factors .....	113
Where Fraud Does Not Occur .....	113
Undetectable Fraud.....	114
Role of the Auditor in Fraud Detection .....	114
Summary .....	115
Review Questions .....	116
Review Answers .....	117
<b>Chapter 7 – Fraud Investigation.....</b>	<b>119</b>
Learning Objectives .....	119
Introduction.....	119

## Table of Contents

Whether to Investigate .....	119
Investigation Policies and Procedures .....	119
Fraud Investigative Techniques .....	120
Documentary Evidence .....	121
Personal Observation .....	121
Physical Evidence .....	122
Testimonial Evidence .....	123
Invigilation .....	123
The Need for Objectivity .....	123
The Need for Investigation Secrecy .....	124
Involving the Police .....	124
Signed Confessions .....	124
Summary .....	124
Review Questions .....	125
Review Answers .....	126
<b>Chapter 8 – Investigation of Concealment and Conversion .....</b>	<b>127</b>
Learning Objectives .....	127
Introduction .....	127
The Chain of Custody .....	127
Organizing the Evidence .....	127
Document Examination .....	128
Conversion and Incarceration Information Sources .....	128
National Crime Information Center .....	128
Interstate Identification Index .....	129
Federal Inmate Database .....	129
Tax Returns .....	129
State-Level Information .....	129
County-Level Information .....	130
Divorce Information .....	130
Probate Court Information .....	130
Professional Licensing Information .....	130
Rental Information .....	130
SEC Filings .....	131
Tax Assessor Information .....	131
Title Information .....	131
Voter Registration Information .....	131
Acquaintances Information .....	132
Trash Analysis .....	132
Fee-based Search Tools .....	132
Investigations Related to Mail Fraud .....	132
Calculating the Amount Stolen .....	132
Summary .....	133
Review Questions .....	134
Review Answers .....	135
<b>Chapter 9 – Fraud Interviewing Techniques .....</b>	<b>137</b>
Learning Objectives .....	137
Introduction .....	137
The Ideal Interviewer .....	137
Types of Interviewees .....	138
The Ideal Interview .....	138
Interview Planning .....	138
The Interview .....	139
Interactions with Friendly Interviewees .....	139
Interactions with Unfriendly Interviewees .....	141
Asking for an Admission of Guilt .....	142

## Table of Contents

Additional Interviewing Rules .....	146
Activities Following the Interview.....	146
Income Questions .....	147
Lifestyle Questions.....	147
Interviewee Motivations.....	147
Reactions to Fraud.....	147
Integrity Testing .....	148
Summary .....	148
Review Questions .....	149
Review Answers .....	150
<b>Chapter 10 – The Fraud Report.....</b>	<b>151</b>
Learning Objectives .....	151
Introduction.....	151
Report Tone.....	151
Sample Text of the Report.....	151
Summary .....	157
Review Questions .....	158
Review Answers .....	159
<b>Chapter 11 – Legal Aspects of Fraud .....</b>	<b>161</b>
Learning Objectives .....	161
Introduction.....	161
Types of Prosecution .....	161
The Civil Litigation Process .....	162
The Criminal Litigation Process .....	162
The Fraud Examiner Role in Lawsuits .....	163
Federal Statutes Covering Fraudulent Activities .....	163
17 CFR 240.10b5-1 – Trading “on the basis of” Material Nonpublic Information.....	164
15 U.S. Code § 78dd-1 – Prohibited Foreign Trade Practices.....	164
18 U.S. Code § 201 – Bribery of Public Officials and Witnesses .....	164
18 U.S. Code § 500 – Money Orders .....	164
18 U.S. Code § 1030 – Fraud and Related Activity in Connection with Computers .....	164
18 U.S. Code § 1037 – Fraud and Related Activity in Connection with Electronic Mail.....	164
18 U.S. Code § 1341 – Frauds and Swindles.....	164
18 U.S. Code § 1342 – Fictitious Name or Address.....	165
18 U.S. Code § 1344 – Bank Fraud .....	165
18 U.S. Code § 1956 – Laundering of Monetary Instruments.....	165
18 U.S. Code § 1961 – Racketeer Influenced and Corrupt Organizations.....	165
26 U.S. Code § 7201 – Attempt to Evade or Defeat Tax.....	165
41 U.S. Code § 8701 – Prohibited Conduct (Kickbacks).....	165
Summary .....	165
Review Questions .....	166
Review Answers .....	167
<b>Glossary.....</b>	<b>169</b>
<b>Index .....</b>	<b>173</b>