

# CONTENTS

Preface	xv
Acknowledgments	xix
<b>1 Fraud: An Introduction</b>	<b>1</b>
Fraud: What Is It? 2	
Fraud: Prevalence, Impact, and Form 3	
Fraud in Historical Perspective 4	
Types of Fraud 5	
Root Causes of Fraud 6	
A Historical Account of the Auditor's Role 7	
Auditing: Ancient History 7	
Growth of the Auditing Profession in the Nineteenth Century 8	
Federal and State Securities Regulation before 1934 9	
Current Environment 10	
Auditors Are Not Alone 12	
Deterrence, Auditing, and Investigation 13	
Conceptual Overview of the Fraud Deterrence Cycle 14	
Corporate Governance 15	
Transaction-Level Controls 16	
Retrospective Examination 16	
Investigation and Remediation 16	
First Look Inside the Fraud Deterrence Cycle 17	
Corporate Governance 17	
Transaction-Level Controls 18	
Auditing and Investigation 20	
<b>2 The Roles of the Auditor     and the Forensic Accounting Investigator</b>	<b>21</b>
The Patrolman and the Detective 22	
Complexity and Change 25	
Auditor Roles in Perspective 28	
Not All Good People 29	
Each Company Is Unique 30	
Role of Company Culture 30	
Estimates 32	
Choices 33	
What Auditors Do 35	
Fraud versus Error 35	
Reasonable Assurance 36	
Materiality 38	

	Bedrock of an Effective Audit	40
	Professional Skepticism	40
	Knowledge and Experience	40
	Independence and Objectivity	41
	SPADE	42
	Auditing Standards Take a Risk-Based Approach to Fraud	42
	Management Override	44
	Regulatory Reaction to Fraud	45
	Financial Benefits of Effective Fraud Management	46
	Conclusion	46
3	Psychology of the Fraudster	47
	Calculating Criminals	48
	Case 1: "It Can't Be Bob"	49
	Situation-Dependent Criminals	49
	Power Brokers	50
	Fraudsters Do Not Intend to Harm	51
	Case 2: "For the Good of the Company"	51
	Case 3: Personal Catastrophes	51
	Case 4: An Educated, Upstanding Citizen	52
	Kinds of Rationalization	55
	Auditors' Need to Understand the Mind of the Fraudster	55
	Conclusion	57
4	Financial Reporting Fraud and the Capital Markets	59
	Targets of Capital Market Fraud	60
	Securities Investment Model	61
	Overview of Financial Information and the Requirement to Present Fairly	62
	Overview of Fraud in Financial Statements	64
	Accounting Irregularities as an Element of Financial Fraud	68
	Some Observations on Financial Fraud	71
	Fraud from Within	71
	Summary	72
5	Auditor Responsibilities and the Law	75
6	Independence, Objectivity, Skepticism	87
	SEC Final Rules for Strengthening Auditor Independence	88
	SEC Regulation of Forensic Accounting Services	88
	Consulting versus Attest Services	92
	Integrity and Objectivity	93
	Independence Standards for Nonattest Services	94
	Professional Skepticism	95

Trust but Verify: A Case Study	96
Trust but Verify: Exploring Further	99
Loose-Thread Theory of Auditing	103
Further Thoughts on the Loose-Thread Theory	106
<b>7 Forensic Investigations and Financial Audits:</b>	
Compare and Contrast	109
<b>8 Potential Red Flags and Fraud Detection Techniques</b>	119
Types of Fraud Revisited	120
Fraud Detection: Overview	121
Laying a Foundation for Detection	124
Assessing the Risk of Fraud	125
Fraud Risk Factors	125
A Word on Information Technology	126
Interpreting Potential Red Flags	127
Importance of Professional Skepticism	129
Revisiting the Fraud Triangle	132
Incentive and Pressure	132
Opportunity	134
Rationalization and Attitude	135
Identifying and Evaluating Risk Factors	137
Discussion among Audit Team Members	138
Information Gathering	140
Other Sources	143
Analytic Procedures	144
Current Company Data versus Company Data from Prior Periods	147
Company Data versus Company Budgets, Forecasts, or Projections	147
Company Data versus Industry Data	
and/or Comparable Company Data	147
Company Financial Data versus Company Operational Data	148
Company Data versus Auditor-Determined Expected Results	148
Analytic Techniques	148
Assessing the Potential Impact	
of Fraud Risk Factors	150
Evaluating Controls	152
Addressing the Identified Fraud Risks	153
Unpredictable Audit Tests	154
Observation and Inspection	155
Financial Statement Fraud: Detection Techniques	157
Revenue Recognition	157
Corruption	158
Summary	160
<b>9 Internal Audit: The Second Line of Defense</b>	161
What Do Internal Auditors Do?	162

Internal Audit Scope of Services	164
The Handoff to Forensic Accounting Investigators and Legal Counsel	166
Perception Problem	167
Complex Corporate Fraud and the Internal Audit	168
WorldCom and the Thornburgh Report	169
Case Studies: The Internal Auditor	
Addresses Fraud	170
No Segregation of Duties—and a Very Nice Car	170
Odd Transportation System	171
A Tragic Circumstance	172
How Many Lunches Can You Buy?	173
Making the Numbers Look Right	173
How Not to Earn a Bonus	174
A Classic Purchasing Fraud	175
The Loneliness of the Internal Auditor	176
Hitting the Jackpot in the Gaming Industry	177
Reporting Relationships: A Key to Empowering Fraud Detection	178
Tomorrow's Internal Auditor, Tomorrow's Management and Board	180

<b>10 Financial Statement Fraud: Revenue and Receivables</b>	<b>183</b>
Improper Revenue Recognition	185
Timing	186
Revenue Recognition Detection Techniques	188
Side Agreements	191
Liberal Return, Refund, or Exchange Rights	192
Channel Stuffing	195
Bill-and-Hold Transactions	196
Early Delivery of Product	198
Partial Shipments	199
Contracts with Multiple Deliverables	200
Improper Allocation of Value in Multiple-Element Revenue Arrangements	201
Up-Front Fees	202
Improper Accounting for Construction Contracts	202
Related-Party Transactions	204
Revenue and Receivable Misappropriation	206
Revenues	207
Receivables	208
Fictitious Sales	209
Lapping	210
Redating	211
Inflating the Value of Receivables	211
Extended Procedures	212
Round-Tripping	215

Improperly Holding Open the Books	216
Consignments and Demonstration Goods	217
Summary	218
<b>11 Financial Statement Fraud: Other Schemes and Misappropriations</b>	<b>219</b>
Asset Misstatements	219
Inventory Schemes	219
Investment Schemes	224
Recording Unrealized Declines in Fair Market Value	226
Recording Fictitious Fixed Assets	226
Depreciation and Amortization	226
Hanging the Debit	227
Software Development Costs	227
Research and Development Costs	228
Start-Up Costs	228
Interest Costs	228
Advertising Costs	229
Understatement of Liabilities and Expenses	229
Off-Balance-Sheet Transactions	230
Two Basic Accounting Models	231
Cookie Jar Reserves	233
Improper and Inadequate Disclosures	234
Materiality	235
Disbursement Schemes	236
Invoice Schemes	236
Check Tampering	239
Expense Reimbursement Schemes	240
Payroll Schemes	242
<b>12 When and Why to Call In Forensic Accounting Investigators</b>	<b>243</b>
Today's Auditors Are Not Forensic Accounting Investigators	244
Auditors Are Not Authenticators	244
Auditors Have Limited Exposure to Fraud	245
Auditors Are Not Guarantors	246
Historically, Audits May Have Been Predictable	247
Potential Trigger Points of Fraud	248
Reliance on Others	255
Conclusion	257
<b>13 Teaming with Forensic Accounting Investigators</b>	<b>259</b>
Forensic Accounting Investigators' Cooperation with Internal Auditors	261
Internal Audit's Position and Function	261
Resource Models	262
Working Together	263

Forensic Accounting Investigators' Cooperation with External Auditors	264
Client History	264
The External Auditor in Today's Environment	265
Objectives of All Interested Parties	266
Forensic Accounting Investigators' Objectives	266
Objectives of Other Parties to the Investigation	267
How Should the Investigation Objectives Be Defined?	269
Who Should Direct the Investigation and Why?	270
Ready When Needed	271
Where to Find Skilled Forensic Accounting Investigators	272
Internal Audit	272
Engaging External Forensic Accounting Investigators	273
Accounting and Auditing Firms	273
<b>14 Potential Missteps: Considerations</b>	
<b>When Fraud Is Suspected</b>	<b>277</b>
Confronting Suspects	277
Dismissing the Target	281
Assumptions	281
The Small Stuff Could Be Important	286
Materiality: More on a Key Topic	287
Addressing Allegations	288
The Case of the Central American General Manager	289
Exercising Skepticism	293
Case Outcomes	294
<b>15 Investigative Techniques</b>	<b>295</b>
Timing	295
Communication	296
Early Administrative Matters	296
Predication	297
What Should You Know before You Start?	299
Gaining an Understanding	299
Gathering and Securing Information	300
Coordination	303
Other	303
A Word about Insurance	304
Exceptions and Other Considerations	305
Document Review	306
ComQuest	306
CPA Services	308
How to Read a Check	308
Airline Tickets	310
Conclusion	311

16	Anonymous Communications	313
	Typical Characteristics of Anonymous Tips	314
	Federal Statutes Related to Anonymous Reporting and Whistle-Blower Protections	315
	Receipt of an Anonymous Communication	318
	Initial Understanding of Allegations	320
	Determine Whether Any Allegation Requires Immediate Remedial Action	320
	Development and Implementation of the Investigative Strategy	321
	The Investigation Team	321
	Disclosure Decisions	322
	Prioritize the Allegations	323
	Interviewing Employees	325
	Follow-Up Tip	329
	Conclusion	330
17	Background Investigations	331
	Commercial Media Databases	332
	Other Public Records	335
	Commercial Database Providers	339
	Other Sources	342
	Unique Internet Sources	342
	Other Government Agencies	345
	International Investigations	346
	Conclusion	346
18	The Art of the Interview	349
	Difficulty and Value of Obtaining an Admission	350
	Planning for the Interview	351
	Types of Interviews	353
	The Information-Seeking Interview	353
	The Admission-Seeking Interview	354
	Others May Wish to Attend Interviews	358
	Interview Process	358
	Documenting the Interview	364
	Summary	364
19	Analyzing Financial Statements	365
	Developing Effective Analytic Procedures	366
	Vertical Analysis	368
	Horizontal Analysis	369
	Ratio Analysis	369
	Reasonableness Testing	369
	Data-Mining Analysis	370

Using Financial Ratios as Measures of Risk or Indications of Fraud	371
Identifying Other Relationships That Might Indicate Fraud	375
Margin Analysis	376
Focus on Disparity of Net Income to Cash Balances	377
Evaluate Increases in Accounts Receivable in Relation to Sales Increases	377
Evaluate Interim Results and Seasonality	377
Common Analytic Pitfalls	377
Identifying Signs of Earnings Management	378
The Beneish Research	378
<b>20 Data Mining: Computer-Aided Forensic Accounting Investigation Techniques</b>	<b>385</b>
Benefits and Pitfalls	386
Benefits	387
Other Considerations	387
Nearly Every Investigation Can Benefit from Forensic Technology	388
Effective Data Mining	389
What Relevant Data Might Be Available?	389
Audit Trails (Traffic Data)	390
Faster/Better/Cheaper	390
Access to Relevant Data	390
Assessing Data Quality and Format	392
Scope of Available Data	393
Quality of Available Data	394
Time Required and Data Requests	394
Data Cleaning	398
Eliminating Duplicate Information	399
Testing the Data for Completeness and Accuracy	400
Understated Amounts	401
Overstated Amounts	402
Incomplete Responses	402
Incomplete Data Sets	402
Skills of the Forensic Technologist	402
Technical Skills	403
Communication Skills	403
Effective Use of Data Analysis Results	404
Role of Data Analysis in the Investigation	404
Data Mining in Action	405
Check Disbursement File	405
Examining the Vendor Master File and Payments History	410
General Ledger Searches	411
Keyword Searches	412
Deleted/Slack/Unallocated Space	414
Data Sorting	415
Choice of Tools	418



Presenting Results	419
Reviewing the Essentials	420
Conclusion	420
<b>21 Building a Case: Gathering and Documenting Evidence</b>	<b>423</b>
Critical Steps in Gathering Evidence	424
Considerations at the Time of Retention	424
Document Retention Considerations	425
Planning Considerations	425
Creating a Chain of Custody	427
Whose Evidence Is It?	430
Evidence Created by the Forensic Accounting Investigator	431
Working Papers	431
Reports	432
What Evidence Should Be Gathered?	433
Investigations of Vendors	433
Investigations of Foreign Corrupt Practices Act Violations	434
Investigations of Improper Related-Party Activity	434
Investigations of Employee Misappropriations	434
Investigations of Specific Allegations	435
Investigations of Financial Statement Errors	435
Important Considerations regarding Documents and Working Papers	435
Conclusion	438
<b>22 Supporting a Criminal Prosecution</b>	<b>439</b>
Key Considerations	440
Deterrent Effect of Appropriate Response	440
U.S. Sentencing Commission Guidelines	440
Expense and Possible Outcomes	442
Referrals for Prosecution May Attract Public Attention	442
Referral Considerations	443
Refer the Matter to State, Local, or Federal Prosecutors?	444
Prosecutors Must Prioritize Cases	445
Forensic Accounting Investigator May Increase the Success of a Referral	446
Reputational Benefits	446
Plea Agreements	447
Filing a Civil Lawsuit	447
<b>23 Report of Investigation</b>	<b>449</b>
Types of Reports	450
Importance of Adequate Preparation	450

Standards of Reporting	451
AICPA Consulting Standards	451
ACFE Standards	453
The Written Report of Investigation	455
Basic Elements to Consider for Inclusion in a Report of Investigation	455
Summarizing Your Findings	457
Written Report of Expert Witness Opining for the Plaintiff on a Civil Fraud Claim	458
Affidavits	460
Informal Reports	461
Giving a Deposition	462
Be Prepared	463
It's <i>Your</i> Deposition	463
Objectives of a Deposition in Civil Litigation	464
You Are Being Measured	464
Reviewing Your Deposition Transcript	465
Other Considerations	465
Mistakes to Avoid in Reporting	466
Avoid Overstatement	467
Avoid Opinion	467
Identify Control Issues Separately from Investigative Findings of Fact	467
Use Simple, Straightforward Language Focused on the Facts	467
Avoid Subjective Comments	468
Working Papers	469
Signed Engagement Letter	469
Relationship Review	471
Substantive Working Papers	471
Each Working Paper Should Stand on Its Own	471
Testimony Binder	473
Interview Memorandums	473

## 24 Working with Attorneys 475

In the Company of Lawyers	475
Confidentiality Requirements	477
Forming the Investigative Team	477
Documentation	483
Civil Litigation	485
Interviewing	485
External Audit Firm	486
Working for or Interacting with Law Enforcement or Government Agencies	489
Disagreements with Counsel	490
Conclusion	491

<b>25</b>	<b>Conducting Global Investigations</b>	<b>493</b>
	On International Assignment 494	
	Getting Started 495	
	Coordinating the Engagement 496	
	Logistics 497	
	Work Plan 497	
	Preliminary Work Plan Example 498	
	Foreign Corrupt Practices Act 501	
	Internal-Accounting-Control Provisions 502	
	Antibribery Provisions 502	
	Record-Keeping Provisions 502	
	Additional Considerations 503	
	Planning the Engagement 503	
	Accounting Issues 503	
	Knowledge of Corporate Personnel 504	
	Understand Company Policy 504	
	Understand the Company's Network 504	
	Local Licenses 505	
	Schemes and Other Matters 505	
	Personal Considerations 507	
 <b>26</b>	 <b>Money Laundering</b>	 <b>509</b>
	Relationship between Fraud and Money Laundering 510	
	Placement 511	
	Layering 511	
	Integration 511	
	Varying Impact of Money Laundering on Companies 512	
	The Five-Point Program for AML-Regulated Businesses 514	
	Written Compliance Program 514	
	Minimum Standards of Customer Due Diligence 514	
	Activity Monitoring and Reporting 514	
	Training 515	
	Record Keeping 515	
	Impact of Money Laundering on Financial Statements 517	
	AML and Forensic Accounting Investigation 518	
	At the Request of the Regulator 518	
	At the Request of the Institution 518	
	Review of Transactions and Records 519	
	Decision Making 519	
	The AML Reporting Process 519	
	Corporate Culture and AML Corporate Governance 520	
	Legal Arrangements Lending Themselves to Anonymity 520	
	Potential Red Flags 521	
	Auditing and Money Laundering 522	
	Relationship between Fraud Investigation and AML 523	

27	Other Dimensions of Forensic Accounting	525
	Construction	526
	Environmental Issues	527
	Intellectual Property	528
	Government Contracting	529
	Insurance and Business Interruption	530
	Marital Dissolution	530
	Shareholder Litigation	531
	Business Valuation	532
	Business Combinations	532
	Cybercrime	533
28	Looking Forward: The Future of Forensic Accounting Investigation	535
	Evolving Discipline	536
	New Tools	538
	Education and Training: To Better Support the New Discipline	538
	Regulation and Enforcement	539
	Changing Corporate Environment	540
	Internal Audit	541
	Corporate Judgment Calls	542
	Forensic Accounting Investigators Serving Individual Corporate Clients	542
	Nonfinancial Operating Data	543
	Responsibility for Disclosure and Validation of NFOD	544
	Other Legal and Stock Exchange Requirements	545
	Future of Forensic Accounting Investigation: Increasingly Global	546
	Index	547