



Second Edition

Forensic Accounting *and* Fraud Examination

William S. Hopwood

Jay J. Leiner

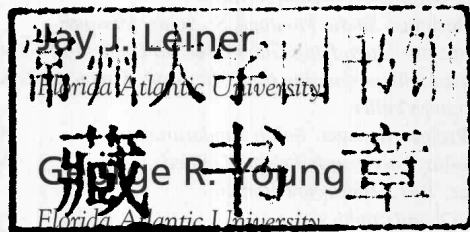
George R. Young

Forensic Accounting and Fraud Examination

Second Edition

William S. Hopwood

Florida Atlantic University



**Mc
Graw
Hill**

**McGraw-Hill
Irwin**



FORENSIC ACCOUNTING AND FRAUD EXAMINATION, SECOND EDITION

Published by McGraw-Hill, a business unit of The McGraw-Hill Companies, Inc., 1221 Avenue of the Americas, New York, NY 10020. Copyright © 2012 by The McGraw-Hill Companies, Inc. All rights reserved. Previous edition © 2008. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of The McGraw-Hill Companies, Inc., including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QDB /QDB 1 0 9 8 7 6 5 4 3 2 1

ISBN 978-0-07-813666-5

MHID 0-07-813666-0

Vice President & Editor-in-Chief: *Kimberly Meriwether David*

Editorial Director: *Stewart Mattson*

Publisher: *Tim Vertovec*

Executive Editor: *Richard T. Hercher, Jr.*

Editorial Coordinator: *Danielle Dalo*

Assistant Marketing Manager: *Dean Karampelas*

Project Manager: *Melissa M. Leick*

Design Coordinator: *Brenda A. Rolwes*

Cover Designer: *Studio Montage, St. Louis, Missouri*

Cover Images: *Magnifying Glass Over US Dollar Bills: © Comstock Images/Alamy; Man Sitting In Office:*

Photo used with permission from Microsoft; Financial Report: © Brand X Pictures

Buyer: *Laura Fuller*

Media Project Manager: *Balaji Sundararaman*

Compositor: *Laserwords Private Limited.*

Typeface: *10/12 Times New Roman*

Printer: *Quad/Graphics*

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

Library of Congress Cataloging-in-Publication Data

Hopwood, William S.

Forensic accounting and fraud examination / William S. Hopwood, Jay J. Leiner, George R. Young.—2nd ed.
p. cm.

ISBN 978-0-07-813666-5 (alk. paper)

1. Forensic accounting—United States. 2. Forensic accounting and fraud examination. I. Leiner, Jay J.

II. Young, George R. III. Title.

KF8968.15.H67 2012

363.25'6--dc22

2011001151

To all the faculty and staff in the Forensic Accounting Masters Program at Florida Atlantic University.

William Hopwood

I dedicate this book to my family and friends; to my wife, Diane; my sons, Victor and Peter; and Mom and Ezio for always believing in me; to my real friends and partners, the old inter-diction team (you know who you are), thanks for being there for me and pushing me that little extra step; to my coauthors, Bill and George, for supporting me and asking me to join them as a coauthor; and last, but not least, to the Broward County Sheriff's Office for giving me the opportunity to investigate cases and to Florida Atlantic University for the opportunity to educate others.

Jay Leiner

I dedicate this book to my father, George, and my mother, Wilma; my wife, Sherry, and my sons, Joshua and Angelo.

George Young

About the Authors

William S. Hopwood, PhD *Florida Atlantic University*

William S. Hopwood is Professor of Accounting at Florida Atlantic University. He earned his master's and doctoral degrees in accounting at the University of Florida. He served as Associate Professor at the University of Illinois at Urbana-Champaign, Professor at The Florida State University, and Arthur Andersen Professor at the University of Houston. He has published many articles in *The Accounting Review*, *Journal of Accounting Research*, and other major accounting journals. He is also coauthor of the widely used Prentice-Hall text, *Accounting Information Systems*. He currently serves as the faculty liaison and technology coordinator for the Master of Accounting in Forensic Accounting Program at Florida Atlantic University.

Jay J. Leiner, BA, BS, MA, CFE, CFS, CHS

Florida Atlantic University

Jay J. Leiner is Adjunct Professor in the Forensic Accounting Master's Program at Florida Atlantic University. He is also in charge of the Economic Crime Unit in the Broward County Sheriff's Office and Team Leader of the Broward County Sheriff's Office Hostage Barricade Team. He has been in law enforcement for more than 25 years and has experience in testifying in both federal and state courts in many areas including money laundering, white-collar crime, and narcotics interdiction. He holds bachelor degrees in criminal justice and accounting and a master's degree in management. He is a Certified Fraud Examiner and Certified Fraud Specialist and is certified in Homeland Security. He has specialized training in electronic surveillance, financial and computer fraud, and organized crime. He is presently seeking his doctorate in business with a minor in Homeland Security.

George R. Young, PhD, CPA *Florida Atlantic University*

George R. Young is Associate Professor at Florida Atlantic University and a Certified Public Accountant in the State of Illinois, where he practiced public accounting for nine years before entering academia. He earned a master's degree in accounting (concentration in taxation) from Southern Illinois University at Carbondale and a doctorate in accounting from the University of Texas at Arlington. Currently, he is the academic director of the Master of Accounting in Forensic Accounting Program at Florida Atlantic University and teaches tax fraud and advanced auditing in that program. He served as a member of the Technical Working Group for Education in Fraud and Forensic Accounting, an effort sponsored by a Department of Justice grant and coordinated by West Virginia University. This group was charged with recommending a model educational curriculum in fraud and forensic accounting to assist academic institutions, public and private employers, and interested students in determining the relevant knowledge, skills, and abilities needed to function as a forensic accountant. At the present time, he is a member of the Higher Education Advisory Committee of the Association of Certified Fraud Examiners. He has published articles in academic journals such as *Auditing: A Journal of Practice & Theory*, *Advances in Accounting Behavioral Research*, and *Research on Accounting Ethics* and in practice journals such as the *Journal of Accountancy*, *The CPA Journal*, and *Internal Auditor*.

Preface

WHAT'S NEW IN THE SECOND EDITION

Because of a general increase in the demand for fraud investigation services, the second edition adds five new chapters relating to fraud investigation processes. The result is that, as revised, Part II (Chapters 5–12) covers the entire fraud investigation process over the span of eight chapters. Parts III and IV (Chapters 13–18) follow up with various types of fraud applications that range from employee and vendor fraud to anti-money laundering and counterterrorism.

A major distinction of the second edition is that it follows a process-oriented approach. This means that fraud investigation is presented as an organized sequence of steps that start at some point and end at some other point. Flow diagrams are presented throughout Part II (Chapters 5–12) to graphically illustrate the sequence of steps followed in fraud investigations.

The process-oriented approach differs significantly from taxonomy-based approaches commonly followed in the literature. Taxonomy-based approaches tend to focus on classifying fraud investigation methods. Although useful, taxonomy approaches in and of themselves do not provide the most basic guidance needed by a fraud investigator, namely what to do first, second, and so on, and when to end a given phase of an investigation.

TEXT ORGANIZATION

The text seeks to provide comprehensive coverage of fraud examination and forensic accounting through a wide range of topics relevant to all types of students, regardless of their major, concentration, or level of studies. The chapters are organized into five major parts. Part I deals with topics primarily relevant to the fraud examination and forensic accounting environment. Part II introduces the theory, processes, and methods of fraud examination. Part III focuses on occupational and organizational fraud. Part IV deals with various specialized nonoccupational areas of fraud. Part V highlights forensic accounting services whose applications are typically outside the area of fraud examination.

PART I INTRODUCTION TO FORENSIC ACCOUNTING AND FRAUD EXAMINATION

This part covers various foundational areas of importance to fraud examination and forensic accounting. Chapter 1 provides a general overview. Chapter 2 focuses on the legal procedures that are frequently relevant to forensic accounting work. Both criminal and civil procedures are covered, with a special emphasis on criminal procedures because they are often ignored in the typical business law courses.

Chapters 3 and 4 provide comprehensive, self-contained units in accounting information systems and auditing. Inclusion of these chapters makes the text accessible to nonaccounting majors and even to nonbusiness majors.

PART II FRAUD EXAMINATION THEORY, PRACTICE, AND METHODS

This part discusses basic and advanced fraud examination and investigation processes. The flow of chapters in this section corresponds to the entire fraud investigation process: fraud prevention (Chapter 5), fraud detection (Chapter 6), fraud investigations and the engagement process (Chapter 7), the fraud evidence collection process (Chapter 8), physical,

documentary, and observational evidence (Chapter 9), interview methods (Chapter 10), forensic science and computer forensics (Chapter 11), and fraud reports, litigation, and the recovery process (Chapter 12).

PART III OCCUPATIONAL AND ORGANIZATIONAL FRAUD

This part features specific areas of occupational and organizational fraud. Chapter 13 deals with employee and vendor fraud. Chapter 14 focuses on financial statement fraud. Chapter 15 highlights fraud and the Sarbanes-Oxley Act.

PART IV SPECIALIZED FRAUD AREAS

This part focuses on specialized areas in which frauds typically originate from specific types of individuals outside of the organization. Chapter 16 deals with tax fraud; Chapter 17 with frauds relating to bankruptcy, divorce, and identity theft; and Chapter 18 with organized crime, money anti-money laundering, and counterterrorism.

PART V OTHER FORENSIC ACCOUNTING SERVICES

This part discusses forensic accounting services not directly related to fraud. Chapter 19 deals with business valuation, and Chapter 20 focuses on dispute resolution and litigation services.

TEACHING APPROACHES AND THE SELECTION OF CHAPTERS

Chapters are written in a modular, self-contained fashion so that instructors can select chapters from each of the five major parts according to specific course requirements. Some basic teaching approaches are as follows:

Comprehensive Focus

Following this approach, an instructor can cover all, or almost all, chapters over a single school term. The auditing and accounting systems chapters could be skipped if students have completed prerequisite courses in these areas.

Fraud and Auditing Focus

Following this approach, the instructor would cover the following chapters in Part I: Chapters 1 (introduction) and 2 (legal) and Part II, Chapters 5–12 (fraud investigation processes). These chapters can then be followed by selected fraud-related applications from Part IV, Chapters 13–18 (fraud applications).

Forensic Accounting Focus

Following this approach, the instructor would cover Chapters 1–2 (introduction and legal), Chapters 5–12 (fraud investigation processes), and Chapters 19–20 (forensic accounting services).

Eclectic Focus

Because the chapters are self-contained and modular, the instructor can select any desired set of chapters to meet particular course needs. Furthermore, the chapters in Part III can be covered in almost any order.

ACKNOWLEDGMENTS

The authors would like to thank the following forensic accounting educators for their input during the development of the first and second editions of *Forensic Accounting and Fraud Examination*. The feedback from these knowledgeable instructors provided the authors valuable assistance in meeting the needs of the forensic accounting classroom.

Second Edition

Phyllis Belak, *West Chester University of Pennsylvania*
 Michael J. Danaher, Jr., *Binghamton University*
 Maurice Goldings, *Nova Southeastern University*
 Robert Hurt, *California State Polytechnic University—Pomona*
 Paula L. Irwin, *Muhlenberg College*
 Chih-Chen Lee, *Northern Illinois University*
 Ransom McClung, *Florida State University*
 Madhuri Sarin, *West Virginia University Institute of Technology*
 Michael Shapeero, *Bloomsburg University of Pennsylvania*
 Robert Terrell, *University of Central Oklahoma*
 Karen Forrest Turner, *University of Northern Colorado*

First Edition

David E. Booth, *Community College of Baltimore County—Essex Campus*
 Nat R. Briscoe, *Northwestern State University of Louisiana*
 James A. DiGabriele, *Montclair State University*
 Randall E. LaSalle, *West Chester University of Pennsylvania*
 Bonita Peterson-Kramer, *Montana State University—Bozeman*
 Barbara Reider, *University of Montana*

Brief Table of Contents

PART ONE

Introduction to Forensic Accounting and Fraud Examination 1

- 1** Introduction to Forensic Accounting and Fraud Examination 3
- 2** The Forensic Accounting Legal Environment 15
- 3** Fundamentals I: Accounting Information Systems 47
- 4** Fundamentals II: The Auditing Environment 81

PART TWO

Fraud Examination Theory, Practice, and Methods 129

- 5** Fraud Prevention and Risk Management 131
- 6** Fraud Detection 167
- 7** The Fraud Investigation and Engagement Processes 195
- 8** The Evidence Collection Process 223
- 9** Fraud Examination Evidence I: Physical, Documentary, and Observational Evidence 247
- 10** Fraud Examination Evidence II: Interview and Interrogation Methods 285

- 11** Fraud Examination Evidence III: Forensic Science and Computer Forensics 325

- 12** The Fraud Report, Litigation, and the Recovery Process 355

PART THREE

Occupational and Organizational Fraud 384

- 13** Employee, Vendor, and Other Frauds against the Organization 385
- 14** Financial Statement Fraud 411
- 15** Fraud and SOX Compliance 439

PART FOUR

Specialized Fraud Areas 467

- 16** Tax Fraud 469
- 17** Bankruptcy, Divorce, Identity Theft 511
- 18** Organized Crime, Counterterrorism, and Anti-Money Laundering 541

PART FIVE

Other Forensic Accounting Services 583

- 19** Business Valuation 585
- 20** Dispute Resolution Services 623

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*

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	154
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
Fraud Detection and Enterprise Risk Management	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
Data-Driven Fraud Detection	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
Steps in Building a Fraud Detection System	184
Summary	187
Glossary	188
Review Questions	189
Discussion Questions	191
Cases	192

Chapter 7

The Fraud Investigation and Engagement Processes 195

The Fraud Investigation Process	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
The Fraud Engagement Process	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

Introduction	223
<i>Embezzlement Case Example</i>	223
<i>The Investigator's Role in Building a Case</i>	225
The Evidence Collection Process	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
Application of the Fraud Theory Approach to Guide the Evidence-Gathering Process	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

Introduction	247
Physical Evidence	248
Documents and Records	249
Sources of Documentary Evidence	250
<i>Personnel Files</i>	250
<i>Résumés</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
Analytical Procedures and Audit Techniques	256
<i>Analytical Procedures</i>	256
Questioned Document Analysis	265
<i>Questioned Documents</i>	265
Observational Evidence	267
Choice of the Appropriate Evidence-Gathering Technique	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
<i>Preparing for the Interview</i>	286
<i>Conducting Multiple Interviews</i>	288
<i>Conducting the Individual Interview</i>	288
<i>Using Interview Techniques</i>	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
<i>Participants in Forensic Science Investigations</i>	325
<i>Types of Evidence Used in Court</i>	329
<i>Testimonial Evidence</i>	334
<i>Investigatory Tools in Forensic Science</i>	335
Computer Forensics	335
<i>Essential Considerations in Computer Forensic Investigations</i>	336
<i>Steps in Forensic Investigation of Computers</i>	338
Law Enforcement Databases and Networks	345
<i>Automated Fingerprint Identification System (IAFIS)</i>	345
<i>National DNA Index System (NDIS)</i>	345
<i>Combined DNA Index System (CODIS)</i>	345
<i>National Integrated Ballistics Information Network (NIBIN)</i>	345
<i>National Law Enforcement Telecommunications Systems (NLETS)</i>	345
<i>National Crime Information Center (NCIC)</i>	
<i>Network</i>	345
<i>Financial Crimes Enforcement Network (FinCEN)</i>	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
<i>Uses of Fraud Investigation Reports</i>	355
<i>Elements of a Fraud Report</i>	359
<i>The Investigator's Liability in Writing a Fraud Investigation Report</i>	360
Fraud Loss Recovery	361
<i>Accept the Fraud Loss</i>	361
<i>Collect Insurance</i>	361
<i>Litigate</i>	363
Expert Testimony	364
<i>Expert Consultants and Discovery</i>	364
<i>Expert Witnesses</i>	365
<i>Pretrial Issues for Expert Witnesses</i>	369
<i>Trial Tactics and Principles Concerning Experts</i>	370
<i>Professional and Ethics Guidelines for Expert Witnesses</i>	371
<i>Legal Liability of Expert Witnesses</i>	372
Summary	372
Glossary	375
Review Questions	375
Discussion Questions	380
Cases	381

PART THREE OCCUPATIONAL AND ORGANIZATIONAL FRAUD 384

Chapter 13

Employee, Vendor, and Other Frauds against the Organization 385

The Fraud Problem in Perspective	385
<i>People Who Commit Fraud against the Organization</i>	387
<i>Employee Fraud and Corporate Culture</i>	389
Employee Fraud Schemes	390
<i>Revenue Cycle Fraud</i>	390
<i>Accounts Receivable Fraud</i>	392
<i>Expenditure Cycle Fraud</i>	394
<i>Production Cycle Fraud</i>	395
<i>Other Types of Employee Fraud</i>	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 & Robbins: Financial Statement Fraud</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

Part I

Introduction to Forensic Accounting and Fraud Examination