tart or an experienced investigator, with industry-tested methods for detecting, investigate, and preventing financial schemes.

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AARON J. SINGLETON, CPA, CISA, has worked for five years at a global public accounting firm performing information technology, financial statement, and regulatory compliance audits. Aaron’s prior experience includes managing accounting and systems for technology, financial statement, and regulatory compliance audits. The authors have clearly explained both in their earlier edition and now they have enhanced the first with additional materials. The order in which the material is presented is easy to grasp and logically follows the ‘typical’ fraud examination from the awareness that something is wrong to the court case. The explanatory materials presented aid this effort by being both well placed within the book and relevant to the narrative.

—Dr. Douglas E. Ziegenfuss, Chair and Professor, Department of Accounting, Old Dominion University

“Fraud Auditing and Forensic Accounting is a masterful compilation of the concepts found in this field. The organization of the text with the incorporation of actual cases, facts, and figures provides a logical and comprehensive basis for learning the intricacies of fraud examination and forensic accounting. The authors successfully blend the necessary basics with advanced principles in a manner that makes the book an outstanding resource for students and professionals alike.”

—Ralph J. Sommerford, President of Forensic/Strategic Solutions, PC

“Finally someone has written a book that combines fraud examination and forensic accounting. The authors have clearly explained both in their earlier edition and now they have enhanced the first with additional materials. The order in which the material is presented is easy to grasp and logically follows the ‘typical’ fraud examination from the awareness that something is wrong to the court case. The explanatory materials presented aid this effort by being both well placed within the book and relevant to the narrative.”

—Dr. Timothy A. Pearson, Director, Division of Accounting, West Virginia University, Executive Director, Institute for Fraud Prevention

“Tommie and Aaron Singleton have made important updates to a book I personally rely very heavily upon: Fraud Auditing and Forensic Accounting (FAFA). In the newest edition, they take difficult topics and explain them in straightforward, accessible language. All my students benefited from reading the third edition of the FAFA to better understand the issues and area of fraud and forensic accounting. With their singular focus on understandability and practicality, the Fourth Edition of this book makes a very important contribution to academics, researchers, practitioners, and students.”

—Ralph Q. Summerford, President of Forensic/Strategic Solutions, PC

Fourth Edition

Inside this book, you will find step-by-step keys to fraud investigation and the most current methods for dealing with fraud all drawn from a wide variety of actual incidents.

FRAUD AUDITING AND FORENSIC ACCOUNTING

TOMMIE W. SINGLETON
AARON J. SINGLETON

FULLY UPDATED AND REVISED, THE NEW EDITION PRESENTS:

¢ Brand-new chapters devoted to fraud response as well as to the physiological aspects of the fraudster
¢ A closer look at how forensic accountants get their job done
¢ More about Computer-Assisted Audit Tools (CAATs) and digital forensics
¢ Technological aspects of fraud auditing and forensic accounting
¢ Extended discussion on fraud schemes
¢ Case studies demonstrating industry-tested methods for dealing with fraud

In the Fourth Edition, we have taken the responsibility of detecting and preventing fraud as a priority, sharing with you all the tools and strategies necessary to catch it in time. Providing valuable information to those responsible for dealing with prevention and discovery of financial deception, Fraud Auditing and Forensic Accounting, Fourth Edition helps accountants develop an investigative eye toward both internal and external fraud and provides tips for coping with fraud when it is found to have occurred.

Completely updated and revised, the new edition presents:

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In this Fourth Edition, we provide you, whether you are a beginning forensic accountant, a seasoned professional, or an experienced investigator, with industry-tested methods for detecting, investigating, and preventing financial schemes.
Fraud Auditing and Forensic Accounting
Fraud Auditing and Forensic Accounting

Fourth Edition

TOMMIE W. SINGLETON
AARON J. SINGLETON

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When times are good, people steal. When times are bad, people steal more!

This quote was made casually in a conversation by Tommie to an academic colleague, but does represent the raison d’être for the new edition of this book. Since time immortal, there have always been a number of humans who are bent in their ethics, morals, sociological makeup, psychological makeup, or sense of justice, and are ready, willing, and able to commit crimes of all types, including white-collar crimes. But hard economic times seem to cause a few more than normal to crumble under the economic pressure and give in to the temptation to commit a fraud.

The Association of Certified Fraud Examiners (ACFE) did an empirical study in 2009 on the effect of the weak economy on the number of frauds being detected by CFEs, entitled “Occupational Fraud: A Study of the Impact of an Economic Recession.” Based on the results of the responses of 507 CFEs, more than half indicated that the number of frauds had increased since the recession began (37.3 percent slight increase, 18.1 percent significant increase). About 49 percent also saw an increase in the dollar amount of the losses due to fraud. Obviously, and empirically evident in the ACFE study, pressure has increased on an increasing number of people due to the recession. And as all antifraud professionals know, pressure is a key to the occurrence of frauds. Therefore, there is a greater need than ever for corporations, companies, and government agencies to be vigilant to protect assets that are more precious than ever.

We are proud to be a part of the fourth edition of this book. The book begins with a general background about fraud auditing and forensic accounting in
Chapter 1. Chapters 2 through 5 provide the basics of fraud such as fraud schemes, how they are perpetrated, what red flags (similar to fingerprints) exist for certain types of schemes, understanding the fraudster, and a fraud risk assessment to identify weak areas. Chapters 6 through 8 follow the “PDC” model for the antifraud profession: prevent, detect, and correct (respond). Chapters 9 through 12 cover the information technology (IT) aspects of fraud including the computer as an instrument of fraud, the target of fraud, and the fact systems are “data warehouses” that contain evidence of fraud. Chapter 13 focuses on the nonfinancial aspects of fraud investigation. Chapters 14 through 16 focus on the legal disposition of a fraud investigation and the major legal concepts, principles, and help for fraud auditors and forensic accountants, especially related to evidence and expert testimony. Chapter 17 is written specifically for public accounting and CPAs.

The material has been slightly reorganized from the third edition to make reading and assimilation of the content easier. New material includes updates in fraud response (a new Chapter 8), computer-related fraud (Chapter 9), cyber forensics (Chapter 12), physiological aspects of the fraudster (a new Chapter 13), and fraud and the CPA (Chapter 17).

We hope this book enables and empowers auditors, CPAs, law enforcement, risk and loss prevention professionals, and all others who have a responsibility related to fraud to better prevent, detect, and respond to fraud.

Tommie W. Singleton
Aaron J. Singleton
August 2010
Acknowledgments

IT IS TRUE THAT anything or anyone visible to the public eye is actually standing on the shoulders of others who made that moment possible. So we would like to acknowledge a few “shoulders.”

First, we want to thank Jack Bologna and Robert Lindquist, authors of the first two editions of this book. In 1992, Dr. Tommie Singleton interviewed Jack Bologna as part of his dissertation at the University of Mississippi on the topic of pioneers in electronic data processing (EDP) audit. Mr. Bologna was indeed a pioneer not only in EDP audit, but also in forensic accounting. Jack was involved with the Association of Certified Fraud Examiners (ACFE) in its early days, was editor for what may have been the first forensic accounting journal in the 1980s, and was an academic who taught forensic accounting. His contributions are a monument and testimony to his knowledge and abilities regarding fraud. Robert Lindquist has a strong reputation of being a fraud expert and is sought after as an expert witness in fraud cases. His work and efforts are stellar, and he is a well-respected professional in Canada and the United States.

Second, we would like to thank some individuals who have helped us in our professional growth. Former FBI agent Alton Sizemore became a supporter and friend to Dr. Singleton about 14 years ago. He is a frequent guest lecturer in Tommie’s classes, even when he was over 100 miles from the university where Dr. Singleton taught for many of those years. He has taught us much regarding the legal elements of fraud, digital evidence, and the law enforcement perspective of fraud. He also has taught us to have fun when circumstances allow it. Indeed, Alton is a favorite of former students for these reasons.

Kevin Andrews has been a supporter, continually involving us in the local chapter of the ACFE. Like Alton, Kevin is a staple in Dr. Singleton’s classes speaking to students about the antifraud profession and how to develop a career as a forensic accountant. He also had a vision of a local, high quality,
Another great friend is Ralph Summerford of Forensic/Strategic Solutions in Birmingham, Alabama. He became a supporter of Dr. Singleton instantly at their first meeting, and has been a faithful, instrumental supporter over the last eight years. No one has been more inspiring or financially supportive of Dr. Singleton’s academic programs than Mr. Summerford.

Another person who has been instrumental in teaching, supporting, and modeling the antifraud profession to us is retired U.S. Treasury investigator Lynn Shobe. Lynn is a key leader in our area, especially for the local ACFE chapter. But he also is an adjunct professor for the forensic accounting program at UAB where Dr. Singleton is the director of that program and an associate professor.

Third, we want to extend a special thank you to Sheck Cho, Wiley editor. He has been a wonderful supporter of our efforts not only on two editions of this book, but on another book as well. Stacey Rivera, our development editor on this edition, was professional throughout, patient and kind, and a joy to work with.
CHAPTER ONE

Background of Fraud
Auditing and Forensic Accounting

There’s a sucker born every minute.
—P. T. Barnum

Trust everyone, but cut the deck.
—P. T. Barnum

INTRODUCTION

In the first decade of the twenty-first century, the news has been filled with reports on frauds and indicators that it is increasing in its scope and costs to the U.S. economy. Almost everyone has read about corporate financial statement frauds such as Enron and WorldCom, or frauds against the government such as false claims following Katrina, or huge Ponzi schemes such as the Madoff scam that set a new record for losses associated with a fraud.
Many people have been directly affected by identity theft. The economic downturn that began in 2008 has made it hard to rebound from such losses. To make matters worse, reports on activities related to fraud bear bad news.

A 2007 report from the Federal Bureau of Investigation (FBI) estimates that fraud in non-health insurance costs more than $40 billion per year, or put another way, costs the average U.S. family between $400 and $700 per year in increased premiums.\(^1\) In the same report, the FBI estimates that costs associated with fraudulent claims following the Katrina hurricane disaster accounted for as much as $6 billion. The FBI also reports that suspicious activity reports (SAR) filed by banks increased 36 percent for 2008 over 2007. Of the SARs filed in 2007, 7 percent indicated a specific dollar loss, which totaled more than $813 million.\(^2\) The FBI was investigating over $1 billion in mortgage frauds in 2008.\(^3\) All these facts existed before the economic meltdown and scrutiny brought to the subprime mortgage industry.

The Internet Crime Complaint Center (IC3) is a federal watchdog agency formed as a partnership of the National White Collar Crime Center (NW3C) and the FBI that serves as a center to receive, process, and refer criminal complaints regarding the rapidly expanding area of cybercrime. Its 2008 Annual Report shows a 33 percent increase in complaint submissions over 2007, which is the trend over this decade. The total losses from 2008 complaints were $265 million with a median loss of $931,000 per complaint.\(^4\)

The National Insurance Crime Bureau (NICB) says that 10 percent of all property or casualty insurance claims, 15 percent of auto theft claims, and 20 percent of workers’ compensation claims involve some form of fraud. According to the NICB, auto insurance theft costs $20 to 30 billion a year. The NICB reports that questionable claims reports in the first half of 2009 has increased 13 percent over first half of 2008 and the numbers in nearly all referral categories are rising as well.

The Association of Certified Fraud Examiners (ACFE) provides periodic surveys of fraud and reports the results to the public in its Report to the Nation (RTTN). Results were published in 1996, 2002, 2004, 2006, and 2008. The 1996 RTTN reported an estimate of over $400 billion in losses due to fraud, which increased over the years to an estimated $994 billion in 2008. Fraud clearly continues to cost organizations and society huge sums of money, both recently and throughout the history of commercial business.
According to some, forensic accounting is one of the oldest professions and dates back to the Egyptians. The “eyes and ears” of the king was a person who basically served as a forensic accountant for Pharaoh, watchful over inventories of grain, gold, and other assets. The person had to be trustworthy, responsible, and able to handle a position of influence.

In the United States, fraud began at least as early as the Pilgrims and early settlers. Since early America was largely agricultural, many frauds centered around land schemes. Perhaps the most infamous colonial era land scheme was the purchase of Manhattan Island (what is now Brooklyn), bought from the Canarsie Indians. The land was bought for trinkets worth about $24. In this case, the Native Americans tricked the white man, as the Canarsie Indians sold land not even connected to Manhattan Island, and Manhattan Island was inhabited by Manhattan Indians, to whom the Dutch had to pay a second time for the land. Land swindles grew as America expanded west.

The advent of business organizations created new opportunities for fraud. The earliest corporations were formed in seventeenth-century Europe. Nations chartered new corporations and gave them public missions in exchange for a legal right to exist, separation of ownership from management, and limited liability that protected shareholders from losses of the business entity. One such corporation, the Massachusetts Bay Company, was chartered by Charles I in 1628 and had a mission of colonizing the New World.

The first major corporate fraud is probably the fraud known as the South Sea Bubble. The South Sea Company was formed in 1711 with exclusive trading rights to Spanish South America. The company made its first trading voyage in 1717 and made little actual profit to offset the £10 million of government bonds it had assumed. South Sea then had to borrow £2 million more. Tension between England and Spain led to the capture of South Sea ships by Spain in 1718. In 1719, the company proposed a scheme by which it would take on the entire remaining national debt in Britain, over £30 million, using its own stock at 5 percent in exchange for government bonds lasting until 1727. Although the Bank of England offered also to assume the debt, Parliament approved the assumption of the debt by the South Sea Company. Its stock rose from £128 in January 1720 to £550 by the end of May that year, in a speculation frenzy.
The company drove the price of the stock up through artificial means; largely taking the form of new subscriptions combined with the circulation of pro-trade-with-Spain stories designed to give the impression that the stock could only go higher. Not only did capital stay in England, but many Dutch investors bought South Sea stock, thus increasing the inflationary pressure.6

Other joint-stock companies then joined the market, usually making fraudulent claims about foreign ventures, and were nicknamed “bubbles.” In June 1720, the Bubble Act was passed, which required all joint-stock companies to have a royal charter. Partly because it had a royal charter, the South Sea Company shares rocketed to £890 in early June 1720. The price finally reached £1,000 in early August, and a sell-off that began in June began to accelerate. The sell-off was begun largely by directors themselves cashing in on huge stock profits. As the stock price began to decline, the company directors attempted to talk up and prop up the stock (e.g., having agents buy stock) but to no avail—the stockholders had lost confidence and a run started in September. By the end of the month, the stock price dropped to a low of £150.

With investors outraged, and as many of them were aristocrats, Parliament was recalled in December and an investigation began. As part of that investigation, an external auditor, Charles Snell, was hired to examine the books of the South Sea Company. This hiring was the first time in the history of accounting that an outside auditor was brought in to audit books, and marks the beginning of Chartered Accountants in England and thus the beginning of Certified Public Accountants (CPAs) and financial audits as we know them today. Thus CPAs owe their profession, at least to a large extent, to a fraud.

In 1721, Snell submitted his report. He uncovered widespread corruption and fraud among the directors in particular and among company officials and their friends at Westminster. Unfortunately, some of the key players had already fled the country with the incriminating records in their possession. Those who remained were examined and some estates were confiscated.

At about the same time, France was experiencing an almost identical fraud from a corporation originally known as the Mississippi Company that had exclusive trading rights to North America in the French-owned Mississippi River area. Using similar tactics of exaggerating the potential profits, the company owner, famous economist John Law, was able to cause a frenzied upward spiral of its stock prices, only to see it collapse after the Regent of Orleans dismissed him in 1720. The company sought bankruptcy protection in 1721. Like South Sea, it was a fraud perpetrated by the exaggerations of executive management.
In 1817, the *Meyer v. Sefton* case involved a bankrupt estate. Since the nature of the evidence was such it could not be examined in court, the judge allowed the expert witness who had examined the bankrupt’s accounts to testify to his examination. Forensic accounting professor and author Dr. Larry Crumbley considers this accountant to be the first forensic accountant in history and the beginning of forensic accounting as a profession.

In 1920, Charles Ponzi planned to arbitrage postal coupons, buying them from Spain and selling them to the U.S. Postal Service, using foreign exchange rates as leverage to make a profit. In order to raise capital for the scheme, he promised outlandish returns to investors—50 percent in 90 days. Ponzi paid the first returns with the cash proceeds from those coming in later, then he personally took the proceeds from later entrants to the scheme. He was imprisoned for defrauding 40,000 people of $15 million. To this day, that type of scheme is referred to as a Ponzi scheme.

In the 1920s, Samuel Insull was involved in a fraud scheme similar to the railroad and South Sea Bubble schemes, but it occurred in the electric utility business. Insull sold millions of dollars of common stock in electric utility companies to unwary investors. The stock was greatly overpriced in terms of the utilities’ real assets. When the stock market collapsed in 1929, it was apparent that Insull’s holding company was insolvent and had been for some time.

Some researchers, such as Dr. Dale Flesher and Dr. Tonya Flesher, have presented sound arguments that the Securities Act of 1933 and the Securities Exchange Act of 1934 are a direct result of the Ivar Kreuger (“Match king”) fraud rather than the stock market crash of 1929. Kreuger & Toll, a multibillion-dollar conglomerate, was a huge fraud built on shell companies and *unaudited financial statements*. Kreuger & Toll securities were among the most widely held in the United States. When the company went under in 1932, after Kreuger had committed suicide, investors lost millions in the largest bankruptcy of its time. Therefore, the argument goes, the existence of these legislative acts requiring financial audits of all companies with listed securities and the Securities and Exchange Commission (SEC) is the result of a major financial fraud, and can be seen by comparing the tenets of the acts against the financial fraud perpetrated by Kreuger versus the stock market crash itself. The acts of 1933 and 1934 essentially created the demand for financial auditors and the CPA profession that exists to this day.

A major savings and loan scandal hit hard in the early 1980s, preceding the energy and telecommunication companies’ frauds in the 1990s. The latter led the seeming explosion of fraud around the last half of the 1990s
and the early 2000s. During this period, high-dollar frauds reached all types of industries. For example, Waste Management in trash services, Pharmor in pharmacy, Sunbeam in manufacturing, Enron in energy, WorldCom in telecommunications, Adelphia in media, Fannie Mae in government, and HealthSouth in health services all occurred during this time. Several of these frauds were among the largest ever, and they occurred during a short period of time.

Although the cost of the WorldCom fraud was far greater, the most notable fraud, as far as impact on the business community, is probably Enron. In 2001, Enron filed bankruptcy after disclosing major discrepancies in revenues and liabilities in its financial reports. The audit firm Arthur Andersen came to an end as a result of the ramifications of the Enron scandal by 2002. In 2002, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) due to that fraud and others, such as WorldCom. Perhaps nothing has brought more attention to fraud audits and forensic accounting than the Enron scandal and SOX.

More recently, the housing and real estate boom of the 2000s has led to increased fraud particularly in the area of mortgage fraud. While the impact of these frauds is not yet entirely clear, mortgage fraud losses for 2007 alone have been estimated to be at least $800 million. SARs from financial institutions indicated an increase in mortgage fraud reporting. SARs increased 31 percent to 46,717 during fiscal year (FY) 2007. The total dollar loss attributed to mortgage fraud is unknown. However, 7 percent of SARs filed during FY 2007 indicated a specific dollar loss, which totaled more than $813 million. Various pieces of legislation have been passed in response, continuing the cycle of evolving frauds and attempts to control them.

Are all of these events merely historical flukes? Did media attention create them? Perhaps. Media attention may have created the original public awareness, but the frauds and corruption were there all the time, and there exists no real way of measuring or comparing them. Part of the problem during the period of time when such large frauds occurred was the mind-set of the regulators and auditors, which has since turned around completely. Claims by management and others are less likely to be accepted at face value, and the financial well-being of the general public is more of a concern to antifraud and audit professions. Suspicion fell on industries, professions, and various areas of government. The undivided attention of auditors, regulators, management, and employees then led to wholesale charges of fraud, theft, and corruption.

The fraud environment can be and often is viewed as a pendulum, swinging from one extreme to the other with little time in between at the
proper balancing point. After 2002, the pendulum was close to an extreme end, one that entailed ultraconservatism on the part of companies, and auditors as well, and the stiffest requirements and enforcement by regulators and legislators. After swinging toward a more balanced position, the recent economic crisis has moved the pendulum back toward the extreme of 2002. This cycle (pendulum swing) is a natural result of human nature, business cycles, and the nature of legislation and regulation. The cycle can certainly be influenced and controlled to some extent, but it will probably never cease.

Fraud auditing literature discloses a common theme: Fraud is endemic and pervasive in certain industries, locales, companies, and occupations at particular points in history. For example, railroad promoters in the 1870s raised more capital from less informed investors than ever before and the railroad industry had numerous frauds exposed. During the 1950s, more doctors were involved in more income tax frauds than ever before or since. Food franchisers, in the late 1960s, are another example of the fraud phenomenon. Some fast-food franchisers sold unwary small investors on untested restaurant concepts at overvalued prices. These half-baked concepts led to the bankruptcy of many of the franchisees. During the Watergate era of the early 1970s, politicians were involved in corruption and fraud against taxpayers, and corporations were involved in political and commercial bribery, leading to the Foreign Corrupt Practices Acts of 1977.

THE FRAUD CYCLE

The fraud cycle essentially begins with the plans of the fraudster leading up to the committing of the fraud act. Once committed, the fraudster converts the asset to cash, if necessary, and conceals the fraud.

The existence of a fraud usually comes to light through (1) an allegation, complaint, or a rumor of fraud brought by a third party (a disgruntled supplier or a fellow employee); (2) an investigator’s intuition or general suspicion that something is awry; (3) an exception from an expectation of a person senior to the suspect (an unacceptable condition, profits, sales, costs, assets, or liabilities are too low or too high); (4) the accidental discovery that something is missing—cash, property, reports, files, documents, or data; (5) results from an audit; or (6) results of controls, especially antifraud controls. Based on the statistics from the ACFE’s RTTNs, an average of about 60 percent of all frauds reported were discovered either by a tip or accident, indicating the need for
more effective proactive detection methods such as internal controls and internal audits.

A fraud investigation is of necessity based on legal factors, because any fraud may end up in a court of law. The immediate facts to determine are whether a fraud has occurred and whether there is: (1) a criminal law, (2) an apparent breach of that law, (3) a perpetrator, and (4) a victim. The six basic steps in the fraud investigation are:

1. Acquire all available details and documents relating to the allegation.
2. Assess the allegation against the available documentation.
3. Assess the corporate environment relative to the person in question.
4. Ask whether a theory of fraud can be developed at this stage. Is there motive and opportunity?
5. Determine whether the available evidence makes sense. Does it meet the test of business reality?
6. Communicate with appropriate parties on the details and status of the fraud.

After performing these steps, two possibilities exist. Either one has identified the fraudster and knows who she is, or one has not. If not, more investigation is necessary. But if one does identify the fraudster, the process becomes critical to what is no longer an investigation, rather a pursuit of legal action.

Evidence gathered may consist of the testimony of witnesses, documents, items (means and instruments, or fruits of the crime), and possibly the confession of the perpetrator. Experienced fraud investigators know what evidence is needed to prove the crime and how to attain that evidence. Typically, interviewing the alleged, or known, fraudster is done only after competent and sufficient data have been gathered, assessed, and reasoned. If prosecution of a civil or criminal charge is sought, evidence must be presented in court—which is where the expert witness skill of a forensic accountant or fraud auditor is valuable. The court, trier of fact, then resolves the charge of fraud ending the fraud cycle. A successful prosecution needs someone who can explain, in layperson’s terms, the records, data, documents, financial information, and files supporting the prosecutor’s position.

This book provides readers with insight into each of these phases of the fraud life cycle. It also delves into the mind and behavior patterns of fraud perpetrators, their schemes, and the evidence they leave behind—from which their crimes can be reconstructed. Every fraud has its own unique wrinkles. All thieves do not
think alike. They tend to be opportunists. Given a set of circumstances that allow them to steal, they take the easiest way, usually weighing risks and rewards carefully. Culprits usually leave trails and sometimes make mistakes. Auditors must learn to look for these signs, or red flags, as they will be referred to in this book. While each fraud is different in some ways, they all have some similarities.

REVIEW OF TECHNICAL LITERATURE

The technical literature begins with criminal and regulatory statutes involving business. For example, such literature includes the Sherman Antitrust Act (1890), the Internal Revenue Act (1913), the Securities Act of 1933 and Securities Exchange Act of 1934, Foreign Corrupt Practices Act (1977), Financial Fraud Detection and Disclosure Act (1986), Health Insurance Portability and Accountability Act of 1996 (HIPAA), Gramm-Leach-Bliley Act of 1999 (GLBA), and of course the Sarbanes-Oxley Act (SOX) (2002). Other applicable laws are related to mail fraud, fraud by wire, and the Federal Trade Commission (FTC). Federal laws that have contributed to the growth of fraud auditing include the Labor-Management Reporting and Disclosure Act, the Welfare-Pension Fund Act, and Employee Retirement Income Security Act (ERISA).

The savings and loans scandals of the early 1980s led to the National Commission on Fraudulent Financial Reporting (commonly known as the Treadway Commission, named after the chair of the Commission), which carried on its work as the Committee of Sponsoring Organizations (COSO), which is still functioning today. According to Treadway Commission findings, the most effective way to prevent financial scandals, such as the savings and loan ones, is for companies to have a strong set of internal controls. The model developed by the group has come to be known as the COSO Model of Internal Controls. It focuses on five key areas of internal controls:

1. Risk assessment
2. Control environment
3. Information and communication
4. Monitoring
5. Control activities

In 1992, the American Institute of Certified Public Accountants (AICPA) adopted the COSO Model as Statement on Auditing Standards (SAS) No. 78,
Consideration of Internal Control in a Financial Statement Audit. The COSO Report was becoming a widely accepted framework for evaluating internal controls, and its acceptance and use was expected to grow. As a result, SAS No. 55 was amended to incorporate the COSO Report framework to provide useful guidance to financial auditors.

In the late 1990s and early 2000s, a strong global economy met an increase in fraud in public companies and a lack of effective oversight. The result was a serious shock to the economy and to society as a whole. Public concern over fraud, in general, erupted to new and seemingly endless heights. Although concern over fraud has decreased some (a natural pendulum effect), the mentality toward fraud has clearly changed and for the better. Another positive result is that these large scandalous frauds have created a greater awareness of the need to further develop the discipline of fraud auditing. However, billions of dollars were lost, creating a serious “black eye” for the financial audit profession, and a wave of legislation resulted.

The latest round of legislation passed in the fight against fraud includes SOX, GLBA, and HIPAA. In the current environment, there is an extremely heightened expectation for businesses, auditors, investigators, and regulators to stop fraud. In order to control fraud, the response spurred by legislation must equal or exceed the energy exerted by fraudsters, which appears to have pervasively infiltrated society.

SOX in particular has greatly affected the awareness of and attention to fraud. The AICPA’s SAS No. 99, Consideration of Fraud in a Financial Statement Audit, codified and complemented many of the tenets of SOX, or best practices in antifraud. The Public Company Accounting Oversight Board (PCAOB), created by SOX and responsible for overseeing standards and enforcement, is setting its own standards affecting internal controls and fraud audits. The bottom line is, management of public companies has to accept responsibility for fraud per SOX and financial auditors have to be active in detecting fraud to comply with SAS No. 99.

SAS No. 99 has two basic requirements for financial statement audits. One is for auditors to exercise professional skepticism; that is, auditors are to be constantly mindful of the potential for fraud. The other is that fraud assessment must be included in audit steps from planning to reporting findings. SAS No. 99 emphasizes that evaluating audit evidence and adjusting the audit is a continual process. The audit team must identify, assess, and respond to fraud risks. Subsequently, the audit team must evaluate the findings of the audit tests and report to an appropriate level of management (usually the audit committee). Documentation must exist for all of these audit steps.
Section 404 of SOX requires management to evaluate the effectiveness of internal controls over financial reporting and to report on their evaluation in the annual report. This section also forces management to state their responsibility for internal controls. The internal control evaluation report and certain financial reports have to be signed by the chief executive officer (CEO) and chief financial officer (CFO), providing a legally enforceable claim. Management’s internal controls must be evaluated by the financial (external) auditors who opine on that evaluation.

SOX also brought about these changes:

- More independent boards of directors (especially the audit committee)
- Increased involvement of the audit committee (especially oversight of management and antifraud programs)
- More financial expertise on the audit committee
- More independent reporting lines (external and internal auditors often report directly to the audit committee)

PCAOB Audit Standards No. 5 (AS 5) and No. 3 (AS 3) both address fraud. PCAOB guidance is applicable to issuers, or public companies, and AICPA guidance (SAS) is applicable to nonissuers, or private companies and issuers. AS 5 adopts many SAS 99 requirements. As part of that adoption, AS 5 (via SAS 99) notes the audit of internal control and the financial statement audit are connected, should be risk-based, and requires the nature, timing, and extent of financial statement audit procedures to be adjusted according to the results of the internal control audit. Results here certainly include any findings regarding fraud. AS 5 references the COSO Internal Control model with regard to managing fraud risk.

SOX, SAS No. 99, and AS 5 contain more details than can be summarized here, but these regulations and technical standards have stimulated similar legislation and standards abroad. Yet the need for fraud-auditing talents is not related solely to compliance with new governmental regulations.

### Forensic Accountant and Audits

It is important to define the term forensic accountant to ensure readers understand concepts and narratives throughout the book. One of the key points to understand about forensic accountants is the difference and roles of financial audits versus fraud audits. This section will discuss some of the issues and differences.
Forensic Accounting Defined

In this book, the term forensic accounting refers to the comprehensive view of fraud investigation. It includes preventing frauds and analyzing antifraud controls. Forensic accounting would include the audit of accounting records in search for evidence of fraud; a fraud audit. A fraud investigation to prove or disprove a fraud would be part of forensic accounting. It also includes the gathering of nonfinancial information, such as interviews of all related parties to a fraud, when applicable. Forensic accounting includes writing a report to management or court. Serving as an expert witness and litigation support are part of forensic accounting.

Although relatively new to the accounting profession, the role of a forensic expert in other professions has been in place for some time. Webster’s Dictionary defines the word forensic as “belonging to, used in, or suitable to courts of judicature or to public discussions and debate.” Accordingly, the term forensic in the accounting profession deals with the relation and application of financial facts to legal problems. Forensic accounting evidence, therefore, is oriented to a court of law.

Financial Auditors, Fraud Auditors, and Forensic Accountants

In the lexicon of accounting, terms such as fraud auditing, forensic accounting, fraud examination, fraud investigation, investigative accounting, litigation support, and valuation analysis are not clearly defined. Some distinctions apply between fraud auditing and forensic accounting. Fraud auditing involves a specialized approach and methodology to discern fraud; that is, the auditor is looking for evidence of fraud. The purpose is to prove or disprove a fraud exists. Historically, forensic accountants, however, have been called in after evidence or suspicion of fraud has surfaced through an allegation, complaint, or discovery.

Forensic accountants are experienced, trained, and knowledgeable in all the different processes of fraud investigation including: how to interview people (especially the suspect) effectively, how to write effective reports for clients and courts, how to provide expert testimony in court, and rules of evidence. The ACFE refers to this definition of forensic accounting as fraud examination. In recent years, the broadest of these terms in the antifraud profession is forensic accounting, which typically refers to the incorporation of all the terms involved with investigation, including fraud auditing; that is, fraud auditing is a subset of forensic accounting.
Fraud investigation usually encompasses about the same thing as a fraud audit except investigation typically involves a lot more nonfinancial evidence, such as testimony from interviews, than a fraud audit. So fraud investigation includes fraud audit but goes beyond it in gathering nonfinancial forensic evidence.

Litigation support refers to a forensic accountant assisting attorneys in prosecuting or defending a case in the legal system. That support can take on a variety of skills but ultimately is intended to conclude with the forensic accountant offering an opinion in a court of law as an expert witness on whether a fraud occurred.

Valuation is a cottage industry of its own that overlaps with fraud. Especially in cases of litigation or insurance investigations, a forensic accountant or equivalent (Accredited in Business Valuation [ABV], Certified Valuation Analyst [CVA]) has to establish a value on the loss associated with a fraudulent event, whether it is a spouse trying to hide assets in a divorce case, or a customer claiming exorbitant losses in an insurance claim, or a victim entity suffering from a bad merger/acquisition that ended in a bankruptcy of the subsidiary.

Financial auditing is a wholly different term that needs to be distinguished from forensic accounting and fraud auditing. Financial auditing typically refers to the process of evaluating compliance of financial information with regulatory standards, usually for public companies, by an external, independent entity. The well-publicized SOX incorporates concepts and procedures to deter and to catch fraud in audits of internal controls over financial reporting. However, the focus of financial audits and financial reporting ultimately is concerned with providing reasonable assurance that a material misstatement to financial statements has not occurred, regardless of the reason.

Financial Auditors

The term financial auditor broadly applies to any auditor of financial information or the financial reporting process. The largest classification of financial auditors is those who work for public accounting firms and perform audits of financial statements for public companies. This classification is the most commonly used in this book when referring to financial auditors.

Financial auditors have expertise in their knowledge of accounting and financial reporting (such as in generally accepted accounting principles [GAAP], PCAOB standards, or International Financial Reporting Standards [IFRS]), auditing (generally accepted audit standards [GAAS]), and how those
standards apply to business transactions. As expressed in the GAAS literature, the most important financial auditing attributes are independence, objectivity, and professional skepticism.

Financial auditors traditionally have been seen as, and to an extent have been, numbers oriented, and their processes have been driven by the audit trail. The financial audit procedures are designed to detect material misstatements, and thus financial auditors focus on misstatements that singularly or in the aggregate are large enough to be material. Fraud auditors and forensic accountants are not constrained by materiality. The discipline of financial auditing has been thought to be almost a checklist of items to complete. In reality, judgment is crucial in financial auditing and has progressively increased in the direction of more dependence on auditor judgment. SOX requirements involve auditor judgment to a large degree; auditors are to understand processes significant to financial reporting and to evaluate management’s controls over those processes. Additionally, auditors are to consider environmental, including soft, intangible, factors in that evaluation.

**Fraud Auditors**

Fraud auditors are generally accountants or auditors who, by virtue of their attitudes, attributes, skills, knowledge, and experience, are experts at detecting and documenting frauds in books of records of accounting and financial transactions and events. Their particular attitudes include these beliefs:

- Fraud is possible even in accounting systems that have tight controls.
- The visible part of a transaction fraud may involve a small amount of money, but the invisible portion can be substantial.
- Red flags of fraud are discernible if one looks long enough and deep enough.
- Fraud perpetrators can come from any level of management or society.

The skills fraud auditors require include all of those that are required of financial auditors, plus the knowledge of how to gather evidence of and document fraud losses for criminal, civil, contractual, and insurance purposes; how to interview third-party witnesses; and how to testify as an expert witness.

Fraud auditors must know what a fraud is from a legal and audit perspective, an environmental perspective, a perpetrator’s perspective, and a cultural perspective. They also need both general and specific kinds of experience. They should have a fair amount of experience in general