

Forensic Accounting

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Chapter 1 Core Foundation Related to Fraud Examination and Financial Forensics

LEARNING OBJECTIVES

- 1-1 Define fraud and identify a potentially fraudulent situation.
- 1-2 Differentiate between fraud and abuse.
- 1-3 Define financial forensics and identify an appropriate methodology for a given financial forensic fact pattern.
- 1-4 Differentiate the roles of auditing, fraud examination, and financial forensics.
- 1-5 Explain the theory of the fraud triangle.
- 1-6 List the legal elements of fraud.
- 1-7 Identify common fraud schemes.
- 1-8 Give examples of nonfraud forensics and litigation advisory engagements.
- 1-9 Describe the fraud examiner/financial forensic professional's approach to investigations.
- 1-10 Explain fraud examination methodology.

True/False

- 1-T/F #1. Fraud or a fraudulent act is one that causes its victim to suffer an economic loss only.
Answer: False

- 1-T/F #2. An immaterial false statement is a legal element of fraud.
Answer: F

- 1-T/F #3. The Sarbanes–Oxley Act (SOX) of 2002 is aimed at accounting staffs, auditing firms, corporate governance, executive management (CEOs and CFOs), officers, and directors.
Answer: F

- 1-T/F #4. All instances of misconduct in the workplace amount to fraud.
Answer: F

- 1-T/F #5. The difference between abuse and fraud may be the difference in consequences – being reprimanded or being fired by the company and prosecuted by the justice system.
Answer: T
- 1-T/F #6. Financial forensics is the application of financial principles and theories to facts or hypotheses at issue in a legal dispute and consists of two primary functions.
Answer: T
- 1-T/F #7. Forensic and Litigation Advisory Services (FLAS) professionals may either work to bolster (if hired by the defendant) or to undercut (if hired by the plaintiff) a case.
Answer: F
- 1-T/F #8. Since forensic accounting works with fact as documented by legal records the reports seldom add an adversarial nature to the engagements, and professionals can expect that their work will be accepted by the opposing side.
Answer: F
- 1-T/F #9. The fraud examiner or forensic accountant can easily identify the assumptions that he/she has made while “thinking out of the box.”
Answer: F
- 1-T/F #10. Under generally accepted auditing standards (GAAS) auditors are not currently responsible for planning and performing auditing procedures to detect immaterial misstatements, regardless of whether they are caused by error or fraud.
Answer: T
- 1-T/F #11. When fraudsters collude, the losses to the victim organization increase more than fourfold.
Answer: T
- 1-T/F #12. Line employees are the principle perpetrators in approximately 39 percent of schemes, yielding company losses of approximately \$150,000.
Answer: F
- 1-T/F #13. The three legs of the fraud triangle are opportunity, perceived benefit, and rationalization.
Answer: F

- 1-T/F #14. Fraud pressures can arise from financial problems, such as living within one's means, greed, high debt, medical bills, investment losses, or educational expenses.
Answer: F
- 1-T/F #15. Rationalization must occur before the act of abuse or fraud.
Answer: T
- 1-T/F #16. Money and ego are the two most commonly observed motivations for fraud and abuse.
Answer: T
- 1-T/F #17. When discussing the costs of fraud and other litigations, by the time a formal investigation is launched and the allegations are addressed within the legal arena, the parties have already incurred substantial cost.
Answer: T
- 1-T/F #18. The dichotomy of fraud is it cannot occur without trust, but commerce can occur without trust.
Answer: F
- 1-T/F #19. The issues addressed by a forensic accountant during litigation must be central to the allegations made by the plaintiff's or defense attorneys.
Answer: F
- 1-T/F #20. One of the best ways to ruin an investigation, fail to gain a conviction, or lose a civil case is to base investigative conclusions on logic and conjecture.
Answer: T

Multiple Choice

- 1-M/C #1. Which statement below correctly states the four elements required to prove larceny?
- A. There must be a taking or carrying away of the money of another without the consent of the owner and with the intent to deprive the owner of its use.
 - B. There was a taking or carrying away, of the money or property of another without the consent of the owner, and with the intent to deprive the owner of its use or possession.
 - C. There was a carrying away, of the property of another without the consent, and with the intent to deprive the owner of its possession.
 - D. There was a taking or carrying away, of the property of another with the intent to deprive the owner of its use or possession.

Answer: B

- 1-M/C #2. The tort, known as conversion is correctly stated as:
- A. the taking of property of another with the intent to deprive the owner of its use or possession.
 - B. an assumption and exercise of the right of ownership over goods or personal chattels belonging to another.
 - C. the carrying away of the property of another without the consent of the owner.
 - D. an unauthorized assumption and exercise of the right of ownership over goods or personal chattels belonging to another, to the alteration of their condition or the exclusion of the owner's rights.

Answer: D

- 1-M/C #3. A person is said to act in a 'fiduciary capacity' when:
- A. the business which he transacts, or the money or property which he handles, is not for his own benefit.
 - B. a relationship exists between the defendant and the plaintiff.
 - C. the action resulted in harm to the defendant.
 - D. he stands in a relation implying normal confidence, trust, and faith.

Answer: A

- 1-M/C #4. Practically speaking, the law generally recognizes a fiduciary duty:
- A. for cashiers and accountants.
 - B. for ordinary employees handling cash and valuables.
 - C. for officers and directors of a company.
 - D. All of the above are recognized as having a fiduciary duty.

Answer: C

- 1-M/C #5. Which of the following acts would not be considered an abuse or abusive?
- A. Surf the Internet while at work.
 - B. Remove small amounts of cash from the cash register till.
 - C. Taking a long lunch or break.
 - D. Using sick leave to see a child's play at school.

Answer: B

- 1-M/C #6. An employee enters the work place on a day off and utilizes the leased plotter/printer for four hours to produce graphics for his child's school play. The lease payment is \$80 per hour and his wages are \$20 per hour. Select the correct statement from the choices below.

- A. This is an abuse at the assumed value of \$400.
- B. This is an instance of fraud at the assumed value of \$400.
- C. This is an abuse at the assumed value of \$320.
- D. This is an instance of fraud at the assumed value of \$320.

Answer: D

- 1-M/C #7. The two primary functions of financial forensics are:
- A. litigation advisory services and investigative services.
 - B. litigation advisory services and expert witness services.
 - C. post event auditing services and investigative services.
 - D. post event auditing services and expert witness services.

Answer: A

- 1-M/C #8. Auditing is responsible for:
- A. litigation support and redemption.
 - B. risk assessment and internal controls.
 - C. risk assessment and calculation of damages.
 - D. business valuation and risk assessment.

Answer: B

1-M/C #9. The interrelationship among auditing, fraud examination, and financial forensics is:

- A. established and maintained by legal structures and justice processes.
- B. constant even while social and cultural pressures are exerted on it.
- C. based on the SOX Act and SAS 99.
- D. dynamic and changes over time.

Answer: D

1-M/C #10. Select the most correct statement from those below.

- A. Timing – Recurring for auditing and fraud examination, nonrecurring for financial forensics.
- B. Objectives – Opinion for auditing and financial forensics, affix blame for fraud examination.
- C. Relationship – Nonadversarial for auditing, adversarial for fraud examination, and independent for financial forensics.
- D. Methodology – Audit techniques for auditing and financial forensics, fraud examination techniques for fraud examination.

Answer: C

1-M/C #11. While a fraud examiner's objective is to determine whether fraud has occurred and who is likely responsible, the financial forensics investigator's objective is to:

- A. calculate financial impact based on formulaic assumptions.
- B. determine whether the allegations are reasonable based on the financial evidence and, if so, the financial impact of the allegations.
- C. Gather the required financial and nonfinancial evidence to examine the allegations independently and determine their financial impact.
- D. attempt to gather sufficient evidence to support or refute the allegation and related damages.

Answer: B

1-M/C #12. According to the ACFE, owners and executives are involved in only about:

- A. 23 percent of frauds and steal approximately \$834,000.
- B. 40 percent of frauds and steal approximately \$834,000.
- C. 64 percent of frauds and steal approximately \$834,000.
- D. 93 percent of frauds and steal approximately \$834,000.

Answer: A

- 1-M/C #13. From the list below, create the typical fraud perpetrator profile.
- A. Male, high school education, young, general labor, and with the company for years.
 - B. Female, high school education, young, general labor, and relatively new to the company.
 - C. Male, post secondary education, middle aged, professional, and with the company for years.
 - D. Female, post secondary education, middle aged, professional, and relatively new to the company.

Answer: C

- 1-M/C #14. The three legs of the fraud triangle are:
- A. Opportunity, Perceived Pressure, and Rationalization.
 - B. Opportunity, Value, and Rationalization.
 - C. Opportunity, Perceived Pressure, and Benefit.
 - D. Timing, Value, and Benefit.

Answer: A

- 1-M/C #15. Financial statement fraud is often attributed to pressures, such as all of the following except:
- A. investment losses.
 - B. meeting analysts' expectations.
 - C. deadlines, and cutoffs.
 - D. qualifying for bonuses.

Answer: A

- 1-M/C #16. M/C Fraud deterrence begins:
- A. with the employer's internal controls.
 - B. in the employee's mind.
 - C. with the fraud examination.
 - D. with regulatory and legal actions such as PCAOB Auditing Standard No. 5, AICPA Statement on Auditing Standards (SAS) No. 99, and the Sarbanes–Oxley Act.

Answer: B

- 1-M/C #17. The acronym “M.I.C.E.” as typical motivations of fraud perpetrators stands for:
- A. Money, Ideology, Coercion, and Environment.
 - B. Money, Ideology, Coercion, and Ego.
 - C. Motive, Ideology, Coercion, and Ego.
 - D. Money, Image, Capability, and Environment.

Answer: B

- 1-M/C #18. When the losses caused by fraud are correlated to the levels of compensation of the perpetrator, the line is somewhat linear, with slow rise from low compensation to approximately:
- A. \$100,000 annually where the rate of loss skyrockets.
 - B. \$300,000 annually where the rate of loss skyrockets.
 - C. \$500,000 annually where the rate of loss skyrockets.
 - D. \$750,000 annually where the rate of loss skyrockets.

Answer: C

- 1-M/C #19. As compensation of the perpetrator increases the losses associated with the perpetrator rise most likely because:
- A. the perpetrator has a greater appreciation of costly pleasures.
 - B. the perpetrator has greater access to company funds and assets.
 - C. the perpetrator has a higher cost of status and image.
 - D. the perpetrator can coerce others into the scheme.

Answer: B

- 1-M/C #20. Small businesses, such as those with less than one hundred employees, account for approximately what percentage of the cases in the 2006 and 2008 ACFE surveys?
- A. 10%-14%
 - B. 35%-27%
 - C. 36%-38%
 - D. 50%-52%

Answer: C

- 1-M/C #21. Which of the follow is not a reason why small businesses have high losses to fraud?
- A. Smaller businesses have fewer personnel doing more jobs.
 - B. Small businesses frequently have external fraud detection units.
 - C. Small businesses frequently have higher degrees of trust between personnel.
 - D. All of the above are reasons why small businesses have higher fraud losses.

Answer: B

- 1-M/C #22. The most common anti-fraud measure used by respondents to the ACFE's National Fraud Survey was:
- A. the external audit of financial statements.
 - B. a formal code of conduct.
 - C. surprise audits.
 - D. job rotation/mandatory vacation policies.

Answer: A

- 1-M/C #23. A common complaint among those who investigate fraud is that:
- A. the adversarial relationship between plaintiffs and fraud examiners resulted in weak cases.
 - B. job rotation policies often result in perpetrators being moved to new positions of responsibility before being exposed.
 - C. companies often conceal the cost of fraud as other business expenses.
 - D. organizations and law enforcement do not do enough to punish fraud and other white-collar offenses.

Answer: D

- 1-M/C #24. In fraud cases where no legal action was taken, the most significant reason for the lack of prosecution was cited as:
- A. that internal discipline was sufficient.
 - B. the fear of bad publicity.
 - C. private settlement was attained.
 - D. the dollar value of the loss was insufficient.

Answer: B

- 1-M/C #25. The most frequently reported method of uncovering occupational fraud was:
- A. by accident.
 - B. through internal audits.
 - C. tips.
 - D. through internal controls.

Answer: C

- 1-M/C #26. Some of the typical forensic and litigation advisory services are:
- A. costs and lost profits resulting from business interruptions.
 - B. assets and business valuations.
 - C. anti-trust actions.
 - D. All of the above.

Answer: D

- 1-M/C #27. Which of the following is not part of or one of the three elements of professional skepticism for a fraud investigation?
- A. An attitude that includes a questioning mind and a critical assessment of the evidence.
 - B. A commitment to persuasive evidence.
 - C. That the plaintiff and/or the defendant may be masking the true underlying story.
 - D. The investigation must reveal a benefit to the plaintiff.

Answer: D

- 1-M/C #28. At a minimum, professional skepticism:
- A. is supportive of client's claim of fraud.
 - B. is a neutral but disciplined approach to detection and investigation.
 - C. assumes that the management is dishonest and therefore must "pull every loose thread" to find the evidence and fraud.
 - D. assumes unquestioned loyalty by newer and younger employees.

Answer: B

- 1-M/C #29. Fraud professionals and forensic accountants use the term red flag to indicate:
- A. that they are looking for symptoms and badges of fraud.
 - B. that all personnel will be investigated.
 - C. that evidence of fraud or abuse have been located and identified.
 - D. that a person or group of people have been identified as possible fraudsters or abuser.

Answer: A

1-M/C #30. Which of the following is not a symptom of one of the six common categories of fraud?

- A. Unexplained accounting anomalies.
- B. Exploited internal control weaknesses.
- C. Where nonfinancial data correlates with financial data.
- D. Anomalies communicated via tips and complaints.

Answer: C

1-M/C #31. Which of the following is not a fraud risk factor?

- A. Is there adequate reward for fraud?
- B. Is there ample opportunity for fraud?
- C. Is there a company culture for a high tolerance of risk?
- D. Is management focused on short-term results or personal gain?

Answer: A

1-M/C #32. Evidence can best be defined as:

- A. only tangible objects legally presented at a trial.
- B. anything perceivable by the five senses and legally presented at trial.
- C. only records, documents, facts, data, or tangible objects legally presented at trial.
- D. only witness testimony accepted by both the plaintiff and defendant.

Answer: B

1-M/C #33. The fraud theory approach involves the following steps, in the order of their occurrence is:

- A. create hypotheses, analyze available data, test the hypotheses, refine and amend the hypothesis, and draw conclusions.
- B. analyze available data, create hypotheses, test the hypotheses, refine and amend the hypothesis, and draw conclusions.
- C. create hypotheses, test the hypotheses, analyze available data, refine and amend the hypothesis, and draw conclusions.
- D. None of the above are in proper order.

Answer: B

- 1-M/C #34. From the statements below select the most correct.
- A. Prevention and deterrence are typically more costly than attempting to remediate a fraud that has already occurred.
 - B. Fraud deterrence refers to creating environments in which people are prohibited from committing fraud.
 - C. Fraud detection refers to the process of preventing and discovering the presence of fraud.
 - D. Prevention and deterrence are typically more cost beneficial than attempting to remediate a fraud that has already occurred.

Answer: D

- 1-M/C #35. Which of the following is not one of the three-pronged processes of remediation?
- A. The prevention and detection of a fraud that has already occurred.
 - B. The recovery of losses through insurance, the legal system, or other means.
 - C. Support for the legal process as it tries to resolve the matter in the legal environment.
 - D. The modification of operational processes, procedures, and internal controls to minimize the chances of a similar fraud recurring.

Answer: A

Short Answer Essay

1-SAE #1. Define “fraud” and define “abuse.” In the process, identify differences between the two.

Answer: “Fraud, sometimes referred to as the fraudulent act, is an intentional deception, whether by omission or commission, that causes its victim to suffer an economic loss and/or the perpetrator to realize a gain. A simple working definition of fraud is theft by deception.” (Text page 2)

“The term abuse has taken on a largely amorphous meaning over the years, frequently being used to describe any misconduct that does not fall into a clearly defined category of wrongdoing. Webster’s definition of abuse might surprise you. From the Latin word *abusus*, to consume, it means: “1. A deceitful act, deception; 2. A corrupt practice or custom; 3. Improper use or treatment, misuse.” To deceive is “to be false; to fail to fulfill; to cheat; to cause to accept as true or valid what is false or invalid.” Given the commonality of the language describing both fraud and abuse, what are the key differences? An example illustrates: suppose that a teller was employed by a bank and stole \$100 from her cash drawer. We would define that broadly as fraud. But if she earns \$500 a week and falsely calls in sick one day, we might call that abuse—even though each act has the exact same economic impact to the company—in this case, \$100. And, of course, each offense requires a dishonest intent on the part of the employee to victimize the company. Look at the way in which each is typically handled within an organization, however: in the case of the embezzlement, the employee gets fired; there is also a possibility (albeit remote) that she will be prosecuted. But in the case in which the employee misuses her sick time, perhaps she gets reprimanded, or her pay might be docked for the day. (Text page 7)

1-SAE #2. What is a “fiduciary duty” and give examples.

Answer: A fiduciary duty is a very high standard of conduct that is not lightly imposed. The duty depends upon the existence of a fiduciary relationship between the two parties. In an employment scenario, a fiduciary relationship is usually found to exist only when the employee is “highly trusted” and enjoys a confidential or special relationship with the employer. Practically speaking, the law generally recognizes a fiduciary duty only for officers and directors of a company, not for ordinary employees. (In some cases a quasifiduciary duty may exist for employees who are in possession of trade secrets; they have a duty not to disclose that confidential information.) If a warehouse employee were to steal computer chips while he/she would not owe a fiduciary duty to his/her employer, he may be guilty of larceny. If an officer of the company stole a trade secret or exposed proprietary manufacturing processes to a competitive third party, the tort of breach of fiduciary duty might apply. (Text pages 3 and 4)

1-SAE #3. Explain what is meant by the term “financial forensics.”

Answer: Financial forensics is the application of financial principles and theories to facts or hypotheses at issue in a legal dispute and consists of two primary functions:

1. Litigation advisory services, which recognizes the role of the financial forensic professional as an expert or consultant, and
2. Investigative services, which makes use of the financial forensic professional’s skills and may or may not lead to courtroom testimony.

Financial forensics may involve either an attest or consulting engagement.

According to the AICPA, Forensic and Litigation Advisory Services (FLAS) professionals provide educational, technical, functional, and industry-specific services that often apply to occupational fraud, corruption, and abuse and to financial statement fraud cases. (Text page 8)

1-SAE #4. Explain the “fraud triangle” and “M.I.C.E.” and compare the two in your explanation.

Answer: The fraud triangle consists of three sides which are required to meet in an “acceptable form” before the perpetrator commits fraud. The sides are perceived opportunity, perceived pressure, and rationalization. All of these values are those of the perpetrator or potential perpetrator, not those of the organization and as such, they may or may not be supported by logic or law.

M.I.C.E. is an acronym standing for Money, Ideology, Coercion, and Ego. As causes to commit the acts of fraud or abuse greed (money) and power (ego) are the two most frequent justifications. Individuals who are less willing to commit the act or acts may be unwillingly be involved in a scheme by force or intimidation (coercion). Ideology is probably the least frequent motivation factor and is a situation where the end justifies the means. “It does not matter if I hurt the investors as long as the corporation pays for their act.” As with the fraud triangle, these are personal values and may or may not be supported by logic or law.

Both the fraud triangle and M.I.C.E. tools are evaluation tools of an individual or group of individuals motivations to commit the act of fraud or abuse. It is generally accepted that the M.I.C.E. concept heuristic oversimplifies fraudulent motivations, and some motivations fit multiple categories, it is easily remembered and provides investigators with a framework to evaluate motive.

1-SAE #5. Intent is a significant problem in fraud investigations and prosecutions. Discuss the issue of intent and explain some of the common problems associated with proving intent.

Answer: Although the fraud triangle provides an effective explanation for the conditions necessary for fraud to occur, which are primarily values measured by the perpetrator, and is a source of red flags that require investigation, in order to prove fraud, the investigator has to deal with the problem of intent. Intent, like all aspects of the investigation, must be grounded in the evidence. In a fraud case, the challenge is that—short of a confession by a co-conspirator or the perpetrator—evidence of intent tends to be circumstantial. The proven events of the act, the concealment of the act, and the conversion of items taken or used in the act, are critical to the investigative process and may all be used to support the issue of intent. However, intent is most often a non-physical element in the thoughts of the perpetrator and not a physical piece of evidence such as a video of the event or bank deposit slip.

Critical Thinking Exercise

Anthony and Cleopatra are lying dead on the floor in a villa. Nearby on the floor is a broken bowl. There is no mark on either of their bodies, and they were not poisoned. With this information, determine how they died.

Answer: Anthony and Cleopatra are fish and they died of suffocation.

Text Review Questions

2-TRQ #1. Define fraud and identify a potentially fraudulent situation.

Answer: Fraud is an intentional deception, whether by omission or co-mission, that causes its victim to suffer an economic loss and/or the perpetrator to realize a gain.

Potentially fraudulent situations may include, for example:

- Misappropriation of funds, securities, supplies, or other assets.
- Impropriety in the handling or reporting of money or financial transactions.
- Profiteering as a result of insider knowledge of company activities.
- Disclosing confidential and proprietary information to outside parties.
- Disclosing to others, securities activities engaged in or contemplated by the company.
- Accepting or seeking anything of material value from contractors, vendors, or persons providing services/materials to the Company.
Exception: Gifts less than US \$50 in value.
- Destruction, removal, or inappropriate use of records, furniture, fixtures, and equipment.

- 2-TRQ #2. Differentiate between fraud and abuse.
Answer: Although both fraud and abuse involve an intentional deception that causes its victim to suffer an economic loss and/or the perpetrator to realize a gain, abuse does not rise to the level of fraud. Abuse is often a way to describe a variety of petty crimes and other counterproductive behavior, such as surfing the web while at work, coming to work late or leaving early, using sick leave when not sick, that have become common and even silently condoned in the workplace.
- 2-TRQ #3. Describe the services that a forensic accountant might provide related to a marital dispute.
Answer: Forensic accountants may assist attorneys with assembling the financial information necessary to either bolster (if hired by the plaintiff) or undercut (if hired by the defendant) a case. This may include, for example, locating hidden marital assets or income, calculating the present value of future cash flow from retirement plans and providing testimony in the case.
- 2-TRQ #4. Explain the differences between an audit, fraud examination, and forensic accounting engagement.
Answer: Audits, fraud examinations, and forensic accounting engagements have six major differences:
- Timing - Audits are conducted on a regular recurring basis while a fraud examination is nonrecurring and is only conducted on sufficient predication. A forensic accounting engagement is also nonrecurring and is only conducted after an allegation of misconduct.
 - Scope - The scope of an audit is general while the scope of a fraud examination or forensic accounting engagement is specific. Audits are a general examination of financial information for material misstatements while fraud examiners and forensic accountants are engaged to resolve a specific allegation.
 - Objective - The objective of auditing is to express an opinion on the financial statements of an organization. The objective of a fraud examination is to determine whether or not fraud has taken place and to determine who is responsible, while a forensic accounting engagement is to determine the financial impact of the allegations.
 - Nature of the relationship - Auditing is non-adversarial while fraud examination is adversarial in nature. The forensic accountant is independent.
 - Methodology - Auditing primarily entails examining financial data, while fraud examination and forensic accounting involve gathering sufficient financial and non-financial evidence to meet their objective.

Approach - Auditors are required to approach an audit with professional skepticism while fraud examiners and forensic accountants attempt to establish sufficient proof to meet their objective.

2-TRQ #5. Explain the theory of the fraud triangle.

Answer: The fraud triangle provides an explanation for the conditions necessary for fraud to occur – perceived pressure, perceived opportunity, and rationalization.

2-TRQ #6. List the legal elements of fraud.

Answer: Under common law, fraud includes four essential elements:

1. A material false statement,
2. Knowledge that the statement was false when it was spoken,
3. Reliance on the false statement by the victim, and
4. Damages resulting from the victim's reliance on the false statement.

2-TRQ #7. Identify common fraud schemes.

Answer: Common fraud schemes include asset misappropriation, corruption, and false statements.

2-TRQ #8. Give examples of nonfraud forensic and litigation advisory engagements.

Answer: Engagements may be criminal, civil or administrative cases that involve economic damage claims, workplace or matrimonial disputes, or asset and business valuations.

2-TRQ #9. Describe the fraud examiner/forensic accountant's approach to investigations.

Answer: Fraud examination and forensic accounting entail examining documents, reviewing records, and interviewing witnesses.

2-TRQ #10. Explain fraud examination.

Answer: Fraud examination involves obtaining documentary evidence, interviewing witnesses and potential suspects, writing investigative reports, testifying to findings, and assisting in the general detection and prevention of fraud.