

Fraud Investigation by External Auditors in Turkey: 2010-2015

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Abstract

The study aims to identify the most frequently investigated occupational fraud schemes in Turkey by external auditors. With this aim questionnaires were distributed to the external auditors in 2010 and 2015. In the questionnaire occupational fraud schemes are classified based on fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE). The participants declared how frequently they have investigated each type of fraud. The research sample consists of 53 external auditors in 2010 and 43 external auditors in 2015. In the results of the study occupational fraud schemes are listed in the order of frequency of investigation. Additionally, the study compares the results of the data that was gathered via questionnaires distributed in 2010 and 2015. According to both 2010 and 2015 studies, the most frequently investigated occupational fraud scheme in Turkey is improper disclosures.

Key Words: Occupational fraud, fraud investigation, external auditors, Turkey

Introduction

Occupational fraud is defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. According to the information gathered by ACFE from more than 1,400 anti-fraud experts who participated in a study, the typical organization loses 5% of annual revenues to all types of fraud. Moreover, the median loss caused by the individual scheme is \$145,000 (ACFE, 2014). As demonstrated in ACFE Report to The Nations on Occupational Fraud and Abuse, the cost of fraud is tremendously high. Therefore, it is crucial to develop effective fraud prevention methods in companies. In order to establish efficient and effective fraud prevention controls in a company, the managers have to be aware of fraud schemes that are pervasively conducted by fraudsters. The widespread fraud schemes might be change from country to country. Consequently, if a company wishes to decrease the cost of fraud by developing a fraud prevention controls, a management must be aware of the most frequently conducted fraud schemes especially in a specific country.

The purpose of the study is to identify the most frequently investigated fraud schemes in Turkey by external auditors. In the study occupational fraud schemes are classified based on fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE). The result of the study demonstrates the most frequently investigated fraud scheme in Turkey is improper disclosures. Furthermore, in the study the fraud schemes are listed in the order of frequency of investigation. The data for the study was gathered via questionnaires used in 2010 and 2015. Additionally, in the research the results of the information obtained in 2010 and 2015 are compared.

Literature Review

In Turkey there are some studies focused on fraud risk factors and fraud detection. Ata et al. (2009), examined the perception of auditors regarding relative importance of fraud risk indicators. The result of the study indicated that "management's effectiveness in control environment" is perceived as the most significant fraud risk indicator by external auditors from Gaziantep, Turkey and London, England. Additionally, in the study "operational and financial stability" is defined as the second most important indicator and "industry circumstances" is defined as the third one. Özbirecekli and Süslü (2005) carried out a survey in order to explore how audit firms in Turkey assess fraud risks. They found that the most common procedure that is exercised by experienced external auditors (more than 40 years old) is "obtaining an understanding of corporate governance system of companies".

In a developed country Apostolou et al. (2001) examined auditors evaluations of the relative importance of 25 management fraud risk factors. They found that “management characteristics and influence over the control environment” red flags are approximately twice as important as “operating and financial stability characteristics” red flags, and about four times as important as “industry conditions” red flags. Furthermore, these three characteristics account for almost 40 percent of the decision weight.

There is a scarce previous study on the frequency of fraud detection or investigation. Loebbecke et al. (1989) reported the results of a survey of KPMG Peat Marwick audit partners as to their experience with material irregularities. The results of their findings demonstrated that such encounters are rare indeed. In terms of the relationship between type of auditor and the degree of fraud detection; Moyes and Hasan (1996) concluded that the degree of fraud detection was not dependent on the type of auditor, since both internal and external auditors have equal abilities to detect fraud.

Academic studies have also investigated whether the length of professional experience is likely to impact the frequency of fraud investigation. Previous academic studies support the statement that longer professional experience is associated with effectiveness of fraud detection. Knapp and Knapp (2001) examine the effects of audit experience on the effectiveness of analytical procedures in detecting financial statement fraud and find that audit managers are more effective than audit seniors in assessing the risk of fraud by means of analytical procedures. Additionally, Bernardi (1994) finds that managers outperform seniors in fraud detection cases when they are exposed to an initial evaluation of client integrity and competence.

Definition and Classification of Occupational Fraud

Occupational fraud is defined as the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets. occupational frauds are those schemes in which a person defrauds his or her employing organization. By its very nature, this form of fraud is a threat to all organizations that employ individuals to perform their business functions.(ACFE, 2014).

Occupational fraud can be classified into three primary categories: asset misappropriation, corruption and financial statement fraud, with each category further broken down into several subcategories as shown in the AppendixIII. Appendix III depicts occupational fraud and abuse classification system (also known as the Fraud Tree) of ACFE. The primary categories of occupational fraud is defined below:

Asset misappropriation is a fraud scheme in which an employee steals or misuses the employing organization’s resources.

Financial statement fraud is a scheme in which an employee intentionally causes a misstatement or omission of material information in the organization’s financial reports

Corruption is a fraud scheme in which an employee misuses his or her influence in a business transaction in a way that violates his or her duty to the employer in order to gain a direct or indirect benefit

In addition to the three primary categories of occupational fraud, ACFE have identified nine sub-categories of asset misappropriation schemes, each representing a specific way that employees misappropriate organizational resources. The sub-categories of asset misappropriation is explained as follows:

Skimming: A scheme in which an incoming payment is stolen from an organization before it is recorded on the organization’s books and records.

Cash Larceny: A scheme in which an incoming payment is stolen from an organization after it has been recorded on the organization’s books and records.

Billing Schemes: A fraudulent disbursement scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices or invoices for personal purchases.

Payroll Schemes: A fraudulent disbursement scheme in which an employee causes his or her employer to issue a payment by making false claims for compensation

Expense Reimbursement Schemes: A fraudulent disbursement scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses.

Check Tampering: A fraudulent disbursement scheme in which a person steals his or her employer’s funds by intercepting, forging or altering a check drawn on one of the organization’s bank accounts.

Cash Register Disbursements: A fraudulent disbursement scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash.

Misuse of Inventories and Other Assets: Any scheme in which an employee misuses non-cash assets of the victim organization.

Inventory and Other Assets Larceny: Any scheme in which an employee steals non-cash assets of the victim organization.

Like asset misappropriation, ACFE has classified financial statement fraud schemes into sub-categories. For this study, financial statement fraud schemes were classified into thirteen categories as follows:

Income Understatements Through Timing Differences for Revenues: Income understatement through timing differences for revenues is a fraudulent scheme that company postpones to recognise the revenue to the following period. As a result, the income of current period is understated while the income of the following period is overstated.

Income Understatements Through Timing Differences for Expenses: A fraudulent scheme that company recognizes following year's expenses in the current year. The fraud understates the current period income and overstates the following period's income.

Income Overstatements Through Timing Differences for Revenues: A fraudulent scheme that company recognizes following year's revenue in the current year. The fraud overstates the current period income and understates the following period's income.

Income Overstatements Through Timing Differences for Expenses: A fraudulent scheme that company postpones to recognise the current period's expense to the following period. As a result, the income of current period is overstated while the income of the following period is understated.

Revenue Understatements: Revenue understatements can occur through booking the revenue in a lower amount than it has accrued.

Fictitious Revenues: Fictitious revenues are created by recording sales that have never occurred. They can involve real or fake customers (Singleton, Singleton, 2010).

Overstated Liabilities: A fraud scheme that can occur through booking the liability in a higher amount than it has accrued.

Concealed Liabilities: Sometimes liabilities such as accounts payable or advances from customers may not be recorded at all. This will boost the asset values in the balance sheet and make the business look good for a while (Trent E.J., 2008). One way to perpetrate this fraud scheme is to postpone the recording of liabilities in the 12th month of the fiscal year so that the current year will have less expenses, and record that liability in the first month of the next fiscal year. Another way is the failure to record liabilities. Without the liability there is no additional expense, no reduction in asset, or no decrease in equity that normally occurs. (Singleton, Singleton, 2010).

Overstated Expenses: A fraud scheme that can occur through booking the current year's expense in a higher amount than it has accrued.

Concealed Expenses: A fraud scheme that can occur through booking the current year's expense in a lower amount than it has accrued.

Income Understatement Through Improper Asset Valuation: Improper asset valuations occur when assets are valued at either greater or less than their cost or net realizable value. This commonly occurs in valuations involving inventory, fixed assets, accounts receivable and business combinations (Montgomery R.J., Majeski W. J., 2005). If assets are overvalued (undervalued) there will be a corresponding overstatement (understatement) to net income. Income understatement through improper asset valuation occurs when assets are undervalued.

Income Overstatements Through Improper Asset Valuation: Inflating the amounts of assets (receivables, inventories, long-lived assets etc.) by capitalizing expenses, or deflating contra accounts, the financial statements will show a higher than thoughtful equity and profit. (Singleton, Singleton, 2010).

Improper Disclosures: Accounting principles require that financial statements and notes include all the information necessary to prevent a reasonably discerning user of the financial statements from being misled. Management has an obligation to disclose all significant information appropriately in the financial statements and disclosed information must not be misleading. Improper disclosures relating to financial statement fraud usually involve the following: liability omissions, subsequent events, management fraud, related-party transactions and accounting changes (Kranacher M. J., Riley R. & Wells J.T. 2011)

According to fraud tree which was published by ACFE, corruption schemes were sub-categorised as: conflict of interest, bribery, illegal gratuities and economic extortion.

Conflict of Interest: A conflict of interest occurs when an employee, manager or executive has an undisclosed economic or personal interest in a transaction that adversely affects the company. The difference between conflict of interest and other corruption frauds is the fact that fraudsters exert their influence (e.g. approving invoices or bills) because of their personal interest rather than because of a bribe or kickback (Singleton, Singleton, 2010).

Bribery: Bribery is a specific form of corruption that can be defined as the voluntary giving of something of value to influence performance of official duty either by doing something improper or failing to do something they should do within the authority of their position. (OECD, 2009) Bribery also can be defined as; offering, giving, receiving, or soliciting anything of value (etc. money) to influence an official act or business decision (Wells J.T., 2008)

Illegal Gratuities: Illegal gratuities are similar to bribery schemes except there is not necessarily an intent to influence a particular business decision. In the typical illegal gratuities scenario, a decision is made which happens to benefit a certain person or company. The party who benefited from the decision then gives a gift to the person who made the decision. The gift could be anything of value (Joshi M. S., 2005).

Economic Extortion: Economic extortion is a form of corruption in which the organization or its employees use some form of economic threat to get the victim to give them money (Skelton R. R., 2011).

Research Methodology

The data for the study was collected through questionnaires. Fraud types are identified based on the occupational fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE). 22 Fraud types are listed in the questionnaire of 2010 and 26 fraud schemes are identified in the questionnaire of 2015. The respondents were asked to indicate the frequency of fraud investigation for each type of frauds. Each questionnaire item was scored on a five-point Likert Scale (1=almost never; 2 = rarely; 3 =occasionally; 4 = frequently, 5=almost always).

A total of 556 questionnaires were distributed to external auditors in May 2010. 56 questionnaires were collected, 3 questionnaires were eliminated due to invalid answers, leaving 53 questionnaires for the empirical analysis. According to 53 questionnaires, occupational fraud schemes investigated by Turkish external auditors are listed in the order of frequency.

In December 2015, a total of 473 questionnaires were distributed, 45 questionnaires were collected and 43 questionnaires were analyzed in the study. Based on 43 questionnaires, occupational fraud schemes are arranged in the order of frequency of investigation. Moreover, the results of 2010 and 2015 questionnaires were compared with the purpose of analyzing the differences over five years.

Results

The sample comprised of 53 external auditors from Turkey in 2010 and 43 external auditors from Turkey in 2015. In the questionnaire the year of experience was asked to the respondents. In the study of 2010; 43.9% of participants have 1-5 years experience, 24.1% of participants have 6-10 years experience, 19.9% of participants have 11-15 years experience, 8.5% of participants have 15-20 years experience, 3.6% of participants have more than 20 years experience. In the study of 2015; 46.5% of participants have 1-5 years experience, 25.6% of participants have 6-10 years experience, 18.6% of participants have 11-15 years experience, 7% of participants have 15-20 years experience, 2.3% of participants have more than 20 years experience.

Table 1. Descriptive Statistics for Professional Experience of Auditors

	External Auditors (2010)		External Auditors (2015)	
		%		%
1-5 years	24	45.3	20	46.5
6-10 years	12	22.6	11	25.6
11-15 years	9	17.0	8	18.6
16-20 years	5	9.4	3	7.0
More than 20 years	3	5.7	1	2.3
	53	100	43	100

In the questionnaire in addition to professional experience, information regarding to fraud education of external auditors were asked. According to the data gathered in 2010, 28 (52%) of Turkish external auditors have fraud education, on the other hand in 2015, 24 (55,8%) external auditors have fraud education. Fraud education percentage increases from 52,8% to 55,8 %. The increase demonstrates that the awareness of the importance of fraud schemes have increased over five years.

Table 2. Descriptive Statistics for Fraud Education of Auditors

	External Auditors 2010		External Auditors 2015	
	2010	%	2015	%
Have fraud education	28	52.8	24	55.8
Do not have fraud education	25	47.2	19	44.2
	53	100	43	100

In both questionnaires conducted in 2010 and 2015, occupational fraud schemes were classified in accordance with occupational fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE). However, 2015 occupational fraud and abuse classification system (fraud tree) is more detailed compare to 2010. Correspondingly, I've slightly modified the questionnaire that was used in 2010 study. The modification of questionnaire was required due to the revision of occupational fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE). Nonetheless, in order to ensure the comparability of the results of 2010 and 2015, I've grouped Income Understatements Through Timing Differences for Revenues, Income Understatements Through Timing Differences for Revenues, Overstated Liabilities, Overstated Expenses and Revenue Understatements into a one group that is labeled Revenue Understatements. Grouping such fraud schemes enables to compare data gathered in 2010 and 2015. According to the results of the survey conducted in 2010 and 2015, Turkish external auditors' frequency of fraud investigation for each type of fraud are given in Table 3.

Table 3. External Auditors' Frequency of Fraud Investigation for Each Type of Fraud

2010				2015			
No	Fraud Types	n	Mean	No	Fraud Types	n	Mean
1	Improper Disclosures	53	3,26	1	Improper Disclosures	43	3,18
2	Timing Differences for Expenses	53	2,98	2	Timing Differences for Expenses	43	3,05
3	Timing Differences for Revenues	53	2,91	3	Concealed Expenses	43	3,01
4	Concealed Liabilities	53	2,81	4	Improper Asset Valuations	43	2,98
5	Revenue Understatements	53	2,74	5	Concealed Liabilities	43	2,97
6	Improper Asset Valuations	53	2,64	6	Timing Differences for Revenues	43	2,95
7	Expense Reimbursement Schemes	53	2,55	7	Misuse of Assets Other Than Cash	43	2,51
8	Conflict of Interest	53	2,53	8	Revenue Understatements	43	2,35
9	Concealed Expenses	53	2,42	9	Fictitious Revenues	43	2,30
10	Misuse of Assets Other Than Cash	53	2,36	10	Expense Reimbursement Schemes	43	2,21
11	Illegal Gratuities	53	2,34	11	Payroll Schemes	43	2,19
12	Asset Understatements	53	2,30	12	Asset Understatements	43	2,09
13	Billing Schemes	53	2,25	13	Billing Schemes	43	2,01
14	Payroll Schemes	53	2,23	14	Larceny of Assets Other Than Cash	43	2,01
15	Fictitious Revenues	53	2,08	15	Illegal Gratuities	43	1,93
16	Check Tampering	53	1,75	16	Economic Extortion	43	1,88
17	Bribery	53	1,75	17	Bribery	43	1,86
18	Larceny of Assets Other Than Cash	53	1,74	18	Conflict of Interest	43	1,86
19	Larceny	53	1,72	19	Check Tampering	43	1,53
20	Economic Extortion	53	1,62	20	Skimming	43	1,51
21	Skimming	53	1,60	21	Larceny	43	1,42
22	Register Disbursements	53	1,58	22	Register Disbursements	43	1,12

As shown in Table 3 improper disclosures is identified as the most frequently investigated fraud schemes by Turkish external auditors both in 2010 and 2015 studies. Even though the frequency of investigation of improper disclosures slightly decreased from 2010 (3,26) to 2015 (3,18), it is still pervasively investigated in Turkey by external auditors.

According to the results of both studies, the second most investigated fraud scheme is timing differences for expenses.

In 2010 study, timing differences for revenues is the third most frequently investigated occupational fraud scheme with a mean of 2,91. According to the 2015 study, the mean of timing differences for revenues is 2,95 out of 5. Although the mean of the timing differences for revenues have increased over five years, the order has decreased from three to six. The result demonstrates that, due to the increase in the frequency of investigation of concealed expenses, improper asset valuations and concealed liabilities, the order of timing differences for revenues have decreased even though the mean has remained constant.

Fictitious revenues is another occupational fraud scheme that needs to be mentioned. According to the result of 2010 and 2015 study, the mean of the frequency of investigation of fictitious revenues is 2,08 and 2,30 respectively. Correspondingly, the order of the occupational fraud increased from fifteen to nine.

As seen in 2010 study, the most frequently investigated occupational fraud schemes are in the form of financial statement fraud. The result is same for 2015 study.

Based on the data gathered in 2015, external auditors in Turkey has been investigated financial statement frauds more frequently than asset misappropriation and corruption schemes. The result is consistent with the purpose of external audit which aims to identify the misstatements due to error or fraud.

Limitations

Eventhough the questionnaire was developed based on the occupational fraud and abuse classification system (fraud tree) of Association of Certified Fraud Examiners (ACFE), the study has some limitations.

First, according to occupational fraud and abuse classification system (fraud tree), the classification of occupational fraud is more detailed in 2015 compare to 2010 (Appendix I and Appendix III). The questionnaire which was conducted in 2010 utilizes the occupational fraud classification system that was published in 2010 and the questionnaire that was distributed in 2015 classifies occupation fraud schemes based on the fraud tree published in 2014. However, eventhough 2014 classification is more detailed for financial statement fraud schemes, I was able to reclassify the information gathered via questionnaire in order to ensure comparability of data of 2010 and 2015 studies.

Another limitation of this study is the overlap of fraud schemes. Although in questionnaire several distinct occupational fraud categories are identified based on occupational fraud and abuse classification system (fraud tree), fraudsters often commit frauds that involve more than one of these schemes.

Conclusion

Eventhough the limitations abovementioned, it iscrucial to identify the most frequently investigated fraud scheme in Turkey. As a result of both 2010 and 2015 studies, improper disclosures is identified as the most frequently investigated fraud sheme in Turkey by external auditors. According to the results of 2010 questionnaires, the second pervasive fraud sheme is timing differences for expenses and the third is timing differences for revenues. The result of the questionnaire conducted in 2015 demonstrates that timing differences for expenses is the secon most common investigated fraud scheme in Turkey and concealed expenses is the third one. Moreover, the reasearch points out that the participation in a fraud education has increased from 2010 to 2015.

Recommendations for Future Studies

In order to establish fraud prevention controls, it is important for management to be aware of the most commonly perpetrated type of fraud schemes. The study identifies the most fraquently investigated fraud shemes. It would be interesting to examine whether the most frequently investigated fraud schemes are indeed helpful in the development of fraud prevenetion controls in Turkish companies. The findings may help researchers to develop a new fraud prevention controls that takes into consideration actual instances of fraud in Turkey.

Appendix I: Occupational Fraud and Abuse Classification System (Fraud Tree) – 2010

CORRUPTION
Conflict of Interest
Purchasing Schemes
Sales Schemes
Other
Bribery
Invoice Kickbacks
Bid Rigging
Other
Illegal Gratuities
Economic Extortion
ASSET MISAPPROPRIATION
Cash
Skimming
Sales
Unrecorded
Understated
Receivables
Write-off Schemes
Lapping Schemes
Unconcealed
Refunds and Other
Cash Larceny
Of Cash on Hand
From the Deposit
Other
Fraudulent Disbursement
Billing Schemes
Shell Company
Non-Accomplice Vendor
Personel Purchases
Payroll Schemes
Ghost Employee
Falsified Wages
Commission Schemes
Workers' Compensation
Expense Reimbursement Schemes
Mischaracterized Expenses
Overstated Expenses
Fictitious Expenses
Multiple Reimbursements
Check Tampering
Forged Maker
Forged Endorsement
Altered Payee
Authorized Maker
Comcealed Checks
Register Disbursement
False Voids
False Refunds

Inventory and All Other Assets
Misuse
Larceny
Asset Requisitions and Transfers
False Sales and Shipping
Purchasing and Receiving
Unconcealed Larceny
FINANCIAL STATEMENT FRAUD
Financial
Asset / Revenue Overstatements
Timing Differences
Fictitious Sales
Concealed Liabilities and Expenses
Improper Asset Valuations
Improper Disclosures
Asset / Revenue Understatements
Non-Financial
Employment Credentials
Internal Documents
External Documents

Appendix II: Occupational Fraud and Abuse Classification in 2010 Questionnaire

	Fraud Types
1	Asset Understatements
2	Revenue Understatements
3	Fictitious Revenues
4	Timing Differences for Revenues
5	Timing Differences for Expenses
6	Concealed Liabilities
7	Concealed Expenses
8	Improper Disclosures
9	Improper Asset Valuations
10	Skimming
11	Larceny
12	Check Tampering
13	Register Disbursements
14	Billing Schemes
15	Payroll Schemes
16	Expense Reimbursement Schemes
17	Misuse of Assets Other Than Cash
18	Larceny of Assets Other Than Cash
19	Bribery
20	Economic Extortion
21	Illegal Gratuities
22	Conflict of Interest

Appendix III: Occupational Fraud and Abuse Classification System (Fraud Tree) - 2014

CORRUPTION
Conflict of Interest
Purchasing Schemes
Sales Schemes
Bribery
Invoice Kickbacks
Bid Rigging
Illegal Gratuities
Economic Extortion
ASSET MISAPPROPRIATION
Cash
Theft of Cash on Hand
Theft of Cash Receipts
Skimming
Sales
Unrecorded
Understated
Receivables
Write-off Schemes
Lapping Schemes
Unconcealed
Refunds and other
Cash Larceny
Fraudulent Disbursement
Billing Schemes
Shell Company
Non-Accomplice Vendor
Personel Purchases
Payroll Schemes
Ghost Employee
Falsified Wages
Commission Schemes
Expense Reimbursement Schemes
Mischaracterized Expenses
Overstated Expenses
Fictitious Expenses
Multiple Reimbursements
Check Tampering
Forged Maker
Forged Endorsement
Altered Payee
Authorized Maker
Register Disbursement
False Voids
False Refunds
Inventory and All Other Assets
Misuse
Larceny
Asset Requisitions and Transfers
False Sales and Shipping

Purchasing and Receiving
Unconcealed Larceny
FINANCIAL STATEMENT FRAUD
Asset / Revenue Overstatements
Timing Differences
Fictitious Sales
Concealed Liabilities and Expenses
Improper Asset Valuations
Improper Disclosures
Asset / Revenue Understatements
Timing Differences
Understated Revenues
Overstated Liabilities and Expenses
Improper Asset Valuation

Appendix IV: Occupational Fraud and Abuse Classification in 2015 Questionnaire

	Fraud Types
1	Income Understatements Through Timing Differences for Revenues
2	Income Understatements Through Timing Differences for Revenues
3	Revenue Understatements
4	Overstated Liabilities
5	Overstated Expenses
6	Income Understatements Through Improper Asset Valuation
7	Fictitious Revenues
8	Income Overstatements Through Timing Differences for Revenues
9	Income Overstatements Through Timing Differences for Expenses
10	Concealed Liabilities
11	Concealed Expenses
12	Improper Disclosures
13	Income Overstatement Through Improper Asset Valuations
14	Skimming
15	Larceny
16	Check Tampering
17	Register Disbursements
18	Billing Schemes
19	Payroll Schemes
20	Expense Reimbursement Schemes
21	Misuse of Assets Other Than Cash
22	Larceny of Assets Other Than Cash
23	Bribery
24	Economic Extortion
25	Illegal Gratuities
26	Conflict of Interest

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