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Forensic Accounting and Financial Crimes: Adopting the Inference, Relevance and Logic Solution Approach

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Abstract

This study examines some basic and common financial crimes in corporate organizations, situating the focus on Nigeria, and by extension, the developing world. No doubt, financial crimes have affected individuals and corporate organizations negatively. Some instances of corporate scandals, occasioned by financial crimes, have put accounting professional bodies into a new perception and paradigm that go beyond statutory audit. This study discusses financial crimes and some basic and common financial crimes in corporate organizations. The review indicates that the motivations for financial crimes are built around some risk factors, which include the incentive (or pressure), opportunity and rationalization surrounding the

financial criminals. This paper canvasses for the intervention of forensic accounting to solve the vexed problems of financial crimes with a further recommendation that the forensic accountant adopts the inference, relevance and logic solution approach (IRLS) in dealing with financial crimes in corporate organizations in Nigeria.

Key words: Forensic Accounting, Financial Crimes, Inference, Relevance, Logic.

Introduction

The true and fair view opinion on the financial statements by the statutory auditors is designed to give credibility to such financial reports. This, in turn, is expected to induce confidence in the users of financial statements that wish to make an investment decision. But going by the growing spate of corporate scandals and collapse of corporate organizations, one has had to argue the relevance and the credibility-building clause of the true and fair view opinion of the statutory auditor. Today; modern organized financial crimes have appeared. Financial crimes such as embezzlement, bribery, bankruptcy, security fraud (EFCC, 2004), among others, have taken the centre stage in the scheme of things; and on the scale of governmental preference. Quite unfortunately, too, is the inability of the statutory auditor constrained by the relevant statutes and standards, to deal with financial crimes (Uwojori and Asaolu, 2009).

Financial crimes today have grown wild, and the emergence of computer software coupled with the advent of internet facilities has compounded the problem of financial crimes. Besides, the detection or minimization of these crimes are made more difficult and committing these crimes much easier. The size and complexity of accounting services and the inability of the statutory auditors further constrained by the related clauses in the company laws and standards, present very visible and poor show of the fight against financial crimes in corporate organizations.

While varied financial crimes in the organizations take different dimensions, some basic and common financial crimes have raised issues and find expression in employee theft, payroll frauds, fraudulent billing systems, management theft, corporate frauds, and insurance fraud, among others. All these, no doubt, remain outside the ambit of the statutory auditor to report on except he is placed on inquiry. The statutory auditor is not primarily bound to detect fraud and errors. His responsibility is defined by Sec. 359 (CAMA,

2004) and the relevant auditing standards. Therefore the consequences and the effects of financial crimes in corporate organizations are very grave where no one else acts.

It is against this background that forensic accounting from the public accounting domain emerges. It responds simply to the growing sophistication and awareness of these crimes. Forensic accounting encompasses three major areas of investigation, dispute resolution and litigation support. Manning (2002) defines it as the combination of accounting, auditing and investigative skills to standard by the courts to address issues in dispute in the context of civil and criminal litigation.

In the light of the problem of financial crimes discussed above, this study aims at appraising how the investigative area of forensic accounting can minimize financial crimes in corporate organizations. By investigation, it is meant the act that determines whether or not certain financial criminal matters like, employee theft, management theft, payroll fraud, corporate fraud, insurance fraud, fraudulent billing schemes, insurance fraud, among others, have occurred.

Literature review

Financial crimes

Financial crimes (FCs) have been variously described in literature. No one description suffices. Wikimedia dictionary on financial crimes describes FCs as crimes against property, involving the unlawful conversion of property belonging to another to one's own. Williams (2005) incorporates corruptions to his description of financial crimes. Other components of FCs cited in William's (2005) description include bribes cronyism, nepotism, political donation, kickbacks, artificial pricing and frauds of all kinds.

The array of components of financial crimes, some of which are highlighted above, is not exhaustive. The EFCC Act (2004) attempts to capture the variety of economic and financial crimes found either within or outside the organization. The salient issues in EFCC's (2004) definition include "violent, criminal and illicit activities committed with the objective of earning wealth illegally... in a manner that violates existing legislation... and these include any form of fraud, narcotic drug, trafficking, money laundering, embezzlement, bribery, looting and any form of corrupt malpractices and child labour, illegal oil bunkering and illegal mining, tax evasion, foreign exchange malpractice including counterfeiting, currency, theft of intellectual

property and piracy, open market abuse, dumping of toxic waste and prohibited goods, etc. This definition is all-embracing and conceivably includes financial crimes in corporate organization and those discussed by provision authors (William, 2005 and Khan, 2005).

At the level of corporate organizations, FCs, were known to have led to the collapse of such organizations. Cotton (2003) attributes the collapse of Enron, WorldCom, Tyco, Adelphia, to corporate fraud. \$460 billion was said to have been lost. In Nigeria, Cadbury Nig Plc whose books were criminally manipulated by management was credited to have lost \$15 million (15 billion Naira). The cases of nine commercial banks were fraudulent and constituted financial crimes. About one trillion naira was credited to have been lost through different means. This is still being investigated by EFCC under the EFCC Act (2004).

Generally, FCs are varied and committed by individuals and institutions. These include:

Employee theft

Silverstone and Sheetz (2004) assert that cash is the favourite of fraudsters; and this accounts for about 77.8% of asset misappropriations in the U.S. According to them, much of cash is taken by outright cash larceny and skimming. Larceny occurs when cash is taken or stolen after it has been recorded. Skimming occurs when theft of cash takes place before cash is recorded. However, majority is done through a more elaborate cash disbursement schemes. This includes some manipulation of the billing of payroll system, fabrication of expenses, reimbursements and cheque tampering. The Association of Certified Fraud Examiners (ACFE)(1996) describes larceny, skimming and elaborate cash disbursement as cash theft fraud.

According to the ACFE's (1996) findings, the process of committing this financial crime by the employee begins when it is realized that the cash produced from accounting transactions into the accounting cycle has two destination points – as petty cash and demand deposit, inclusive of interest-bearing account. Petty cash is stolen by forging authorized signature or creating false vouchers, for reimbursement. For cash met for demand deposit, receipts are forged or prepared and false cheques written. This particularly occurs in a small organization where controls are loose. Besides, where a

long term trusted employee creates an atmosphere of incentive, opportunity, and rationalization, he can engage in cash theft.

At other situations, where the money is so available for the long term trusted employee, he becomes an opportunity taker. With the incentive and opportunity, the employee rationalizes the theft; he sees nothing wrong in taking some money in the pretext of borrowing and to return it later. Since the cash is easier to take than to return, the accrued amount becomes too large to replace and the employee is locked up into an endless round of theft and cover up. The schemes adopted by the employee to execute the planned cash theft fraud could go undetected by the statutory auditor who is not primarily commissioned to detect fraud.

Management thefts

These financial crimes are committed when management over-rides the controls instituted by themselves to prevent the thefts they now commit. These thefts are usually difficult to detect. Shackell (2000) reports the pervasiveness of this type of crime in corporate organizations and concludes that management thefts are difficult to detect. Silverstone and Sheetz (2004) opines that the effects of management misconduct can also have severe consequences for the company's overall morale and set a negative model for employees further down the company's ladder.

Payroll fraud

Payroll departments in organizations could be linked with payroll fraud. The financial crime of payroll fraud is usually fast tracked by a payroll clerk, internet facility or through the connivance and collusion of another staff. The instruments of payroll fraud include ghost employees, inflating hours of work and overtime, as well as overstating expense accounts or medical grounds.

The financial crime of payroll is committed when the payroll clerk uses various criminal practices to avoid being caught in the fraud. Ghost workers could be included on the payroll and salaries paid out to the payroll clerk who forges the signature of the ghost worker and obtains value through third party transactions. Hours of work and overtime could be inflated in connivance with other fraudulent staff of the organization and payment made on the basis of this is shared. A usual case is when medical bills are inflated, and sometimes where employees do not attend hospitals, such bills can even feature at regular or irregular interval and cash or value received by the fraudulent employees. The latter description of financial crime is a common

feature in an organization that accredits on private clinic or hospital for the treatment of its staff. Most times, the statutory auditors constrained by their statutory functions plan their audit procedures to have reasonable expectation of material fraud and errors.

Corporate frauds

Senior management of companies are at the centre stage of this financial crime. Usually, corporate frauds are intended to benefit the company. Categories of these frauds include financial statement fraud, anti-trust violation; securities frauds, tax evasion, false advertising, environmental crimes and the production of unsafe product, corporate frauds against the company deprives the company of its assets especially when the senior management attempts to deceive, conceal and misrepresent materially the financial statements. Financial statement fraud is committed in order to improve earnings. As earnings improve, the stock price also increases. Private organization boosts their loan covenants by artificially and criminally improving the earnings of the organization.

Various methods have been used to achieve this. one such method is window dressing and creation of hidden reserves. The law does not specifically employ the statutory auditor beyond the expression of a 'true and fair view' pinion on the financial statements. Additionally, the relevant auditing standards such as the International Statement on Auditing No 240 (ISA 240), Statement of Auditing Standard No. 110 (SAS 110) and Nigerian Statement of Auditing Standard No 5 (NSAS 5), only empowers the auditors to maintain an attitude of professional scepticism during auditing planning and evaluation of audit evidence. Besides, the auditor's emphasis on fraud and error of material effect is of significance.. This again puts the statutory audit at a log jam to deter fraud let alone financial crimes whose tactics and jimicks are more difficult to unearth that ,to say the least, intentional errors or mistakes.

Money Laundering

This is a financial crime of concealment in the flow of fund. It represents the illegal flow of funds across the borders. Corporate organizations could be victims. The Money Laundering (Prohibition) Act, 2004 ("the Money Laundering Act") makes various provisions prohibiting the laundering of the proceeds of a crime or of any criminal or illegal activity, and provides for appropriate penalties for money laundering infringements. According to the

provisions of the Money Laundering Act, no person or corporation or organisation is allowed to make or accept cash payments of a sum in excess of N500,000.00 or its equivalent in the case of an individual, and N2,000,000.00 or its equivalent in the case of a corporation, unless such cash payment or acceptance is undertaken through a financial institution.

Also, a transfer of funds or securities to or from a foreign country in excess of US\$10,000 or its naira equivalent must be reported to the Central Bank of Nigeria (“CBN”) or the Securities and Exchange Commission (“SEC”) in the case of a public corporation. The mandatory reporting of all monetary transfers to or from outside the country must indicate the nature of the transfer, the amount of the transfer, the names and addresses of the sender and the receiver of the funds or securities that were transferred, and the ultimate beneficiary of the transfer if different from the latter persons. The Nigerian Custom Service (“NCS”) is also mandatorily required to forward all monetary declarations it collates to the Central Bank of Nigeria.

The Money Laundering Act (Prohibition) (2004) of Nigeria is an attempt to arrest the illegal flow of funds into and out of Nigeria including funds from corporate organizations. Top management and opportunist ride on the back of the organization to embezzle funds met for the organization. Joseph (2002) estimates that funds laundered across the globe are between \$300 and \$500 million worldwide. In the context of fund flowing from the organization and committed by staff from within, it is a financial crime from within. The law specifies what constitutes money laundering offences and the liability of directors of financial institutions in the event of money laundering offences. Even though the Act provides that any movement of cash in excess of N500,000.00 or its equivalent in the case of an individual(now one million for individuals, and N2,000,000.00 or its equivalent in the case of a corporation (now ten million for corporate organizations) beyond a certain amount be reported to CBN; this has in most cases not been the case because of the sophistication in the act of committing the crime

Credit Cards and Insurance Fraud

These financial crimes are committed against the company or organization. According to the article on “the growing toll of identity theft retrieved from www.aba.com/industry + issue, the impact of credit card or insurance fraud can be devastating to small retailers. Insurance fraud is committed when insurance claims are inflated; and do not reflect the value of assets for which

the claims are sought. Instances exist where assets such as inventory are burnt up in order to put up insurance claims (Silverstone and Sheetz, 2004).

In Nigeria where the insurance industry is still at infancy, this type of financial fraud is relatively uncommon. However, in the U.S. and some other developed countries, this financial crime is a big issue. In an article retrieved from www.insurancefraud.org/new/study, it was reported that bogus property and casualty claims alone account for 10% of all property and casualty claims.

However, credit cards fraud has assumed a frightening dimension especially with the advent of internet facility or technology. This financial crime is committed when credit cards are misused and accounting records manipulated. The good intention of a corporate policy could be abused. This occurs when a corporate policy that allows personal items to be charged to advance accounts is abused by employee who now charges his or her personal expenses to corporate expense account. Credit cards scams occur where staff of I.T. department ingeniously manipulates the I.T. to allow not-easily noticed fraction of staff salaries to be credited to an account created and set up for the special purpose.

Motivations for financial crimes

1. Corrupt Corporate Culture

The history of criminology has been an attempt to identify the characteristics that distinguish criminals from non-criminals and then to find a theory that explains and predicts criminal behaviour. No general theory exists why there are crimes, and by extension, financial crimes. Fortunately however a body of information exists on criminal behaviour. While arguments are rift on the possibility of settled theory on the predictability of criminal behaviour, it has been submitted logically that financial crimes, just like any other criminal behaviour, is the inevitable outcome of the competitive *ethic of capitalism*. According to this theory, the world is constantly facing images of successes and wealth achieved through the recognition of the economic inequality of winners and losers. The urge to be winners remains the driving force and motivation to commit any crime-financial or otherwise (Wheeler, 1992).

2. Corrupt corporate culture

According to Silverstone and Sheetz (2004), financial crimes are motivated by factors which include a *corrupt corporate culture*. According to them,

when a corrupt culture is lived and practised every day at the workplace, this would constitute enormous pressure to financial crimes: a bad corporate, cultural value leads to the inversion of good corporate values. Loyalty could slip to complicity; criminal behaviour to normal behaviour; team-playing to conspiracy. Sutherland (1949) contends that the fear of dismissal or ostracism in losing the favour of superior could lead to financial criminal behaviour. Moreover, this criminal behaviour could be exhibited in association with those who define such financial criminal behaviour and make it more favourable.

3. Conventionality

In addition, Sutherland (1949) further argues that a white-collar crime or any other financial crime favours conventionality: the white-collar criminals live conventional lives. Such conventionality is their toast and camouflage. Conventionality and stability give the financial crimes the foundation of the trust. Such trust creates the opportunity to commit financial crime. Thus, conventionality(C) and stability(S) leads to opportunity (O) to commit financial crime which is then rationalized(R). This can be expressed, in a model suggested by Sutherland (1949), thus:

$$I + O + R = \text{Crime or fraud} \text{-----equ i}$$

But $I = C + S$, such that

$$C + S + O + R = \text{Crime or fraud} \text{-----equ ii}$$

But according to the above process, commission of fraud ,including financial crimes, is possible when the elements of incentive (pressure) (I), opportunity (O) and rationalization (R) are present and unbroken.

4. Pressure, opportunity and rationalization

By pressure, it is meant anything that causes a person to commit fraud. Opportunity is the ability to commit fraud. Opportunity is created by weak internal controls, poor management oversight, among others; while rationalization involves a person reconciling the act of committing crime with the common notions of decency and trust. The issues (or variables) on the left hand of equation must be broken to prevent the commission of financial crime. This remains the role of the forensic accountant.

Forensic accounting and Irls approach

Forensic accounting has been variously defined and the scope differently stated. According to Manning (2002), forensic accounting is the combination of accounting, auditing and investigative skills to a standard that is required by a court of jurisdiction to address issues in dispute in the context of civil and criminal litigation. The import of this definition is appreciated when the context of civil and criminal litigation is emphasized. It can further be appreciated that forensic accounting utilizes accounting, auditing and investigative skills to assist in legal matters.

According to an article extracted on-line from www.buzzle.com/articles, forensic accounting essentially encompasses three major areas of investigation, dispute resolution and litigation support. Today, the horizons of forensic accounting have been broadened to include litigation support, investigative accounting, criminal matters, corporate investigation regulating compliance, insurance claims, matrimonial dispute and expert witnessing. Forensic accounting, as documented in literature is an offshoot of forensic science and accounting (Zysman, 2004). Forensic science is the application of natural laws to the laws of man (Gumbley 2002). In investigation, the forensic accountant determines whether or not certain criminal matters, including financial crimes, such as securities frauds, employee theft, insurance fraud, management theft, payroll fraud, corporate fraud, among others have occurred. A major part of a forensic accountant is to investigate and then recommend certain action that can be taken to minimize any future occurrence. For the purpose of this paper, we are interested in investigation of financial crimes.

In litigation support, the forensic accountant presents factual evidence of economic issues that are related to any pending or existing litigation. The forensic accountant quantifies damages that could be sustained by all parties to a dispute. The implication is that any value arrived at in any damages must meet the satisfaction of parties to any legal dispute. Issues of dispute during courtroom proceedings can be resolved by the forensic accountant. He does play the role of an expert witness when he testifies in court.

In financial crimes scenarios, the forensic accountant must appreciate the seriousness of a situation and look beyond the game of numbers. It must go beyond being a detective or regular accounting. The field of forensic accounting is the product of forensic science and accounting, Crumbley (2003) describes forensic scientists as the examiners and interpreters of

evidence and facts in legal matters. The science as used have according to Sadiq (2008) involves the examination and interpretation of economic information. Forensic accountant provides information that is used as evidence in the court of law. He investigates, appraises and documents financial fraud and white-collar crimes (such as embezzlement and frauds) by employees, management and other frauds or crimes in the organization. He estimates losses, damages and assets misappropriation and any other complex financial transaction. The whole process ends in the production of report which is tendered to assist in legal adjudication. The forensic accountants, in their investigation, use some investigative techniques in financial crimes. We canvass for the integrated connections of the Inference, relevance and logic solution approach.

The process of inference

The forensic accountant, in the investigation of financial crimes, must undertake preliminary investigation and preliminary advice on amount of damages based on an initial pleading and evidence available at the start of the proceedings. The forensic accountant must identify the key documents that should be made available as evidence. This is because financial crimes are known to be complex and requires more mass of physical and documentary evidence than any other crimes. Therefore, managing evidence of this magnitude especially as it relates to financial crimes in corporate organization is possible through an effective organization. Effective organization is possible when the system in the organization is favourably disposed towards the variables of effectiveness of the organization.

To this end, the forensic accountant as an investigator of financial crimes should have a mastering to marshal the evidence relating to the financial crimes in a way that proves the guilt or the innocence of the fraudsters. In doing this, the forensic accountant must combine the science of judicial proof with a system of visual analysis that sorts, classifies and catalogues every piece of evidence. The forensic accountant could draw from inference in order to prove the guilt or the innocence of the financial criminals. Inference is a critical element in defining guilt or innocence. Inferences must rely on the chain of logic. There should be logical linear sequence of proof of evidence inferred from the mass of physical and documentary evidence. According to Silverstone and Sheetz (2004), however, legal proof must conform to a narrow framework or rigorously enforced rules.

Process of relevance

The forensic accountant must not only infer and expound upon the rules of evidence and their admissibility in financial crimes scenarios, he must ensure that such evidence must be confined to what is relevant. Evidence is relevant if and only if it lends credence to proof or disproof of an issue in contention. Where a piece of evidence in a financial crime leads to a proof or otherwise, then the relevancy clause is proved otherwise it is not. To this end, the forensic accountant must address the confusion over the relevance-versus-non-relevance clause. This confusion arises because cases of financial crimes or other crimes are rarely proven under a singular line of logic. The issue the forensic accountant most contend with is that the relevance and non-relevance of physical and documentary evidence should not be taken on the face value unless the ultimate question to which the fact is directed in de-aggregated and components examined.

The logic rule

The logic rule applied in proof of evidence in the commission of financial crimes could be deductive or inductive. The deductive argument clause provides that the forensic accountant, in an attempt to evidence the process of commission of financial crime, must work from the general proven evidence to the specific. The deductive argument logic has two or more assertions that lead to the conclusion. These assertions could constitute the three parts of deductive argument logic. They have been identified as the major premise, the minor premise and the conclusion. The forensic accountant faced with the choice of deductive logic must weigh the attached assertions on the scale of correctness and verity (Siverstone and Sheetz,2004). According to Schaeken et al (2000), the line of deductive argument should logically lead to a conclusion.

Therefore forming a conclusion, using deductive argument reasoning, in financial crimes investigation, the forensic accountant must relate the minor premise to the major premise and weight their correctness soundness and strength. Where the statements in the major and minor premises are sound, correct and strong, the conclusion reached should be adjudged correct otherwise conclusion becomes a fallacy.

On the other hand, the inductive argument reasoning presupposes a bottom-up reasoning, which works from the specific observations to the broader and more general. This approach is seen as scientific in its methodical approach

to resolving financial crimes. The forensic accountant relies on a series of previous observations to reach a conclusion. While the forensic accountant should rely on both deductive and inductive reasoning in resolving financial crimes, however, in offering evidence in the legal system, the forensic accountant may be exposed to inductive logic which provides more scientific approach on the provision of evidential proof. Additionally, in the process of proof, it is common to allege and prove specific isolated facts and build to a general conclusion.

It is factual that the law and the legal resolution of disputes and crimes are concerned with probabilities and not certainties. Deductive argument is designed to lead to mathematical certainty but the realm of probabilities is within the ambit of inductive reasoning. On account of this, the forensic accountant, in search of proof of evidence of financial crimes in organizations, would stretch from specificity to generalization, from a series of previous observations to reach a conclusion.

However, the forensic accountant should not be carried away with or dragged into the fallacies of hasty generalization and exclusion associated with inductive argument logic. These fallacies, however, could be reduced when the forensic accountant carefully analyse the line of argument transposed over the specific legal elements towards the ultimate proposition of guilt or innocence.

Conclusion and remarks

This study x-rays financial crimes in corporate organizations and how forensic accounting can minimize them. To this end, and in line with the investigative skills of the forensic accountant, the IRLS approach of investigating financial crimes was canvassed. The investigative accounting skills of the forensic accountant empower him to address the problem of financial and any other crimes. It was acknowledged that motivation for financial crimes beside being corrupt organizations culture cultivated and practiced daily, the ethic of capitalism and “the-end-justified-the-means” syndrome (Wheeler, 1996), is boosted by the unbroken interaction of the three integrated elements of incentive (also called pressure), opportunity (modified to include conventionality and stability) and rationalization. To deter the commission of financial crimes, the accountant must sever the chain of risk factors suggested by Sutherland’s (1946) model. One way is to infer from the mass of judicial proof and relate it to visual analysis of evidence which should rely on the chain of logic. Besides, the evidence so drawn must be

adjudged relevant as well as meet the test of deductive and inductive argument reasoning. Moreover, the evidence must be free from all fallacies when transposed against legal elements towards the ultimate proposition of proving either guilt or innocence.

Meanwhile, it is suggested that future study should address inference network analysis and inference model in order to prove that an ultimate fact rests solely on the strength of the inferences and not just the evidence. Perhaps, too, future empirical study on this area is advised. This will enable a clear picture of the linkage between IRLS approach by the forensic accountant and in resolving financial crimes in Nigeria.

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