CHAPTER 1

What Is Fraud?

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Why does someone become an auditor or fraud investigator? What does an auditor or fraud investigator hope to accomplish for him- or herself and the organization?

For some, the notion of fraud, or at least the desire to prevent fraud, factored heavily in their decision to pursue the audit or fraud examiner profession. For others, the concept of fraud only became an issue when they started work and had to deal firsthand with fraud detection and prevention. Since the National Commission on Fraudulent Financial Reporting (known as the Treadway Commission) released its report in October 1987, fraud has been an increasingly important issue, particularly for members of the audit profession. The commission raised the issue of responsibility for the deterrence of fraud, and made it front page news. It also increased awareness in the business community of the prevalence of fraud and laid the groundwork for auditing standards and practices regarding fraud.

Starting in the late 1990s, there has been an even greater increase in the prominence of fraud detection. Further, courts have ruled heavily against internal and external audit companies and auditors who did not adequately address the detection of fraud or the protection of clients and stockholders from the negative effects of fraud. The large-scale problems at WorldCom and Enron have emphasized not only the importance of audit but also the devastating effects fraud can have on a company and its auditors. Accounting firms found themselves liable for millions of dollars and were forced to rethink the issue of fraud detection. In addition, governments have developed new rules and regulations to ensure accurate financial reporting, such as the Sarbanes-Oxley Act.

Fraud is not a rare occurrence or one that happens only in other companies. While the exact magnitude of losses to fraud is difficult to determine, in part because of undetected frauds, one study reported that most organizations lose between 0.5 and 2.0 percent of their revenues to fraudulent acts committed by their employees, vendors, and others. A survey by KPMG Forensic determined that employees were responsible for 60 percent of

P1: OTA/XYZ P2: ABC
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the losses.[1] A 1997 report by the Association of Certified Fraud Examiners places losses to fraud at 6 percent of gross revenue.[2] A 1997 study by Deloitte and Touche found that international fraud across the European Union costs members 60 billion euros a year.[3] The PricewaterhouseCoopers 2003 *Global Economic Crime Survey* states that 37 percent of companies worldwide have suffered from a fraud in the last two years, with an average loss of $2 million.[4]

All of the studies seem to indicate that the cost of fraud has increased substantially over the past 10 to 15 years. The 2003 PricewaterhouseCoopers survey indicates that most companies expect fraud to increase in the next five years, with the greatest risk being theft of assets, followed closely by computer hacking, virus attacks, and theft of electronic data. Studies also show that fraud occurs in all types of industries and in both small and large firms.

Fraud is costly not only in dollars; it also can have serious nonfinancial effects. To make matters worse, fraud is not something that will go away on its own—it must be discovered and stopped or it will continue to grow. A fraudulent act committed by senior management may affect employee morale and stockholder confidence for many years. About half of the companies responding to the *Global Economic Crime Survey* felt that fraud had its biggest impact on employee motivation and morale. Companies were more concerned that fraud would affect their reputation and business relations than they were about the effect on share price.

What is fraud and why should auditors be concerned about its detection? Surely, this is a management issue; and while most auditors might like to "catch a thief," it is often not their primary role or may not be their organizational role at all. Some organizations even have a separate fraud investigation group. Thus, in the current legal, business, and audit environments, many auditors and audit organizations remain confused about what fraud is, how it happens, who is responsible for its deterrence and detection, and what they should do to deter and detect it.

Auditors, fraud investigators, employees, and management all have roles to play in deterring and detecting fraud. Audit organizations should be well versed in the symptoms of fraud and the steps involved in its detection.

Audit management has an abiding responsibility to ensure that senior management has developed and implemented a corporate fraud policy that details the procedures that will be followed. Senior management is ultimately responsible for the effective and efficient operations of the business, including the protection of company assets and profits from theft and abuse. Management also should foster an atmosphere in which ethical behavior and mutual trust become the first line of defense against fraud. To be successful, antifraud initiatives must begin at the top, permeate all levels

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P1: OTA/XYZ P2: ABC
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of the organization, and be actively documented, communicated, pursued, and enforced. When all players work together and are supported by well-thought-out corporate policies, fraud and its effects can be reduced and even prevented.

Fraud: A Definition

Fraud includes a wide variety of acts characterized by the intent to deceive or to obtain an unearned benefit. The American Institute of Chartered Public Accountants (AICPA) defines two basic categories of fraud: intentional misstatement of financial information, and misappropriation of assets (or theft). Other audit-related agencies provide additional insight into the definition of fraud that can be summarized in this way:

> *Fraud consists of an illegal act (the intentional wrongdoing), the concealment of this act (often only hidden via simple means), and the deriving of a benefit (converting the gains to cash or other valuable commodity).*

The legal definition of fraud refers to cases where a person makes a material false statement—with the knowledge at the time that the statement was false; reliance by the victim on the false statement; and resulting damages to the victim. Legally, fraud can lead to a variety of criminal charges, including fraud, theft, embezzlement, and larceny. Each charge has its own specific legal definition and required criteria, and all of the charges can result in severe penalties and a criminal record.

The *Report to the Nation on Occupational Fraud and Abuse*[5] divides occupational fraud into three major categories: misappropriation (accounting for 88.7 percent of the cases reported), corruption (27.4 percent), and fraudulent statements (10.3 percent).

The median losses reported by type of fraud ranged from $150,000 to over $2 million.

Fraud can be committed not only by an individual employee but also by a department, division, or branch within a company, or by outsiders. It can be directed against the organization as a whole or against parts of the organization. Also, it can be to the benefit of the organization as a whole, part of the organization, or an individual within or outside the organization.

Fraud designed to benefit the organization generally exploits an unfair or dishonest advantage that also may deceive an outside party. Even though it is committed to benefit the organization, perpetrators of such frauds often

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also benefit indirectly from the fraud. Usually personal benefit accrues when the organization is aided by the fraudulent act. Some examples include:

- Improper transfer pricing of goods exchanged between related entities by purposely structuring pricing to intentionally improve the operating results of an organization involved in the transaction to the detriment of the other organization
- Improper payments, such as bribes, kickbacks, and illegal political contributions or payoffs, to government officials, customers, or suppliers
- Intentional, improper related-party transactions in which one party receives some benefit not obtainable in an arm's-length transaction
- Assignment of fictitious or misrepresented assets or sales
- Deliberate misrepresentation or valuation of transactions, assets, liabilities, or income
- Conducting business activities that violate government statutes, rules, regulations, or contracts
- Presenting an improved financial picture of the organization to outside parties by intentionally failing to record or disclose significant information
- Tax fraud

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Fraud perpetrated to the detriment of the organization is generally for the direct or indirect benefit of an employee, outside individual, or another firm. Examples include:

- Misappropriation of money, property, or falsification of financial records to cover up the act, thus making detection difficult
- Intentional misrepresentation or concealment of events or data
- Submission of claims for services or goods not actually provided to the organization
- Acceptance of bribes or kickbacks
- Diversion of a potentially profitable transaction that would normally generate profits for the organization to an employee or outsider.

Why Fraud Happens

Given the risk involved, why do people commit fraud?

Indications from many studies, including interviews with persons who have committed fraud, are that most perpetrators of fraud did not initially set out to commit a crime. Generally, they simply availed themselves of an opportunity. The fraud triangle (see Exhibit 1.1) is used by experts in the

psychology of fraud to explain the reasons for persons committing fraud. The fraud triangle consists of: opportunity, pressure, and rationalization.

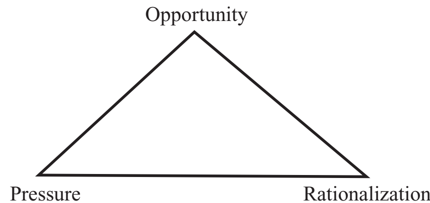

EXHIBIT 1.1 The Fraud Triangle can be used to examine the causes of fraud.

The *opportunity* exists when there are weak controls and/or when an individual is in a position of trust. While the *pressures* on those who commit fraud are often of a financial nature, unrealistic corporate targets may also influence a person to commit fraud to meet the targets. The *rationalization* for fraud often includes these beliefs:

- The activity is not criminal.
- Their actions are justified.
- They are simply borrowing the money.
- They are ensuring that corporate goals are met.
- "Everyone else is doing it" so it must be acceptable.

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The opportunity for fraud often begins when an innocent, genuine error passes unnoticed, exposing a weakness in the internal controls.

Example: System Error

A clerk accidentally processes an invoice twice, and the financial controls do not prevent the second check from being issued.

The internal controls usually exist but are weak; they may have been compromised for the sake of organizational expediency or just eroded over time. A control, such as segregation of duties, may simply be removed as the company downsizes. In other cases controls may be removed or weakened by business reengineering activities. Someone in a position of trust may, because of seniority or position, be able to bypass controls or exploit known weaknesses. Often the internal controls become so weak that there is little or no chance that the person committing the fraud will get caught by the remaining control framework.

Fraud: Action 1

The clerk calls the vendor and requests that a credit be sent to his attention so he can correct the mistake personally.

Psychological and criminal studies have shown that the shift from honest to dishonest behavior results from changes in the fraud triangle. Fraud may start with a perceived opportunity to derive an unearned benefit. It is then rationalized by a belief that the behavior is acceptable or justified. This belief is usually supported and encouraged by a feeling of pressure, often financial.[6] While fraudulent acts may initially be only "questionable," they gradually cross over the line into criminal activity. Yet those caught committing fraud usually do not consider their activities or themselves to be criminal. Rather than being seen as a crime, the fraudulent activity is often seen as a reward for a job well done—such as justified compensation in times when pay increases have been frozen or other compensation the individual thought was deserved. It may even be viewed as a "temporary loan" to help an employee get through a tough financial crisis.

Fraud: Action 2

When the check arrives at the office, the clerk cashes it and keeps the money.

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Pressure

The city raised the property tax bill on his house by 62 percent and he is flat broke.

Rationalization

He has been working a lot of unpaid overtime recently, he deserves the money, and the company can afford it.

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Interviews with persons who have been caught committing fraud show that they often are bothered far more by the first illegal act than by subsequent acts. In any case, once the line is crossed from an honest mistake to fraud, the illegal acts tend to become more frequent, even when the original pressure is removed. If the fraud goes undetected, the fraudulent activity will continue and the dollar amounts will increase. The greed of the person committing the crime and the time it takes to detect the activity seem to be the only limiting factors in the extent of the fraud.

Experience has shown that there is no such thing as a small fraud—just frauds that have not reached maturity. The implication for auditors and fraud examiners is obvious: Fraud will occur, and will continue to grow in size, unless stopped. Obviously, there is a heavy onus on management, audit, and fraud investigators to deter and detect fraud.

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Who Is Responsible for Fraud Detection?

There has been much debate about the role of management versus audit in deterring and detecting fraud and irregularities. The debate gets hotter when a fraud with a long history is suddenly uncovered. This is particularly so if the fraud was uncovered by accident, even though there were regular audits in the area.

A popular line of argument goes like this: Management is responsible for the business on a continuing basis and has (or should have) intricate knowledge of the day-to-day operations. Management also has responsibility for implementing organizational controls. Management "owns" the systems, people, and records that constitute the controls. Therefore, managers should have a complete picture: knowledge of the business risks and controls, plus the authority to adjust business operations. This provides them with ample means and opportunity to make required changes to company operations. Therefore, management, rather than the auditors, should be responsible for the detection of fraud. Of course, we know that it is not that simple.

The counterargument is this: Auditors, especially internal auditors, have expertise in the design, implementation, and evaluation of internal controls. Auditors are on the front line, and they deal with controls every day. Auditors are also experts in risk identification and assessment and may have knowledge of other similar operations. They should already have access to powerful audit software tools and techniques, so they are in the best position to identify fraud and irregularities and to report them to management. Therefore, fraud prevention and detection should be primarily the responsibility of auditors.

In organizations where a separate group conducts fraud investigations, the question of responsibility for prevention and detection may become

P1: OTA/XYZ P2: ABC
c01 JWBT037-Coderre January 19, 2009 16:13 Printer Name: Yet to Come

even more confusing. Where fraud investigators are called in only when a fraud has been detected, they may not see their role as including fraud prevention. However, management may not have the same view.

So who is responsible?

Part of the answer can be found in a variety of evolving auditing standards, such as the *Standards for Professional Practice of Internal Auditing* published by the Institute of Internal Auditors (IIA). The standards discuss various aspects of internal auditing and provide excellent guidance and direction to auditors. They may also provide useful information and direction to fraud investigators. Unfortunately, these standards are not always read and understood by auditors, let alone by management. However, the most critical part of the answer lies in the corporate culture and a mutual understanding among audit, fraud investigators, and senior management.

In discussing the scope of audit work, the IIA standards clearly charge internal auditors with responsibility for reviewing the controls over the safeguarding of assets and ensuring their accurate reporting. Further, audit is responsible for determining if outputs and results are in keeping with the goals and objectives of the business activities being carried out. In performing these responsibilities, internal audit clearly has a role to play in detecting fraud, irregularities, waste, and abuse.

The IIA standards for professional practice also discuss the concept of "due professional care." Internal auditors are informed of the need to be alert to the "possibilities of intentional wrongdoing, errors and omissions, inefficiencies, waste, ineffectiveness, and conflicts of interest." These ideas are presented in more detail in the Statement on Internal Auditing Standards 3 (SIAS 3), *Deterrence, Detection, Investigation and Reporting of Fraud*.

The American Institute of Certified Public Accountants (AICPA) has also published two key Statements on Auditing Standards (SAS) designed to assist auditors in carrying out their responsibilities. Again, fraud examiners can benefit from the information contained in the standards and statements. SAS 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, provides guidelines for auditors in detecting fraud. SAS 99, *Consideration of Fraud in a Financial Statement*, an update to SAS 82, provides additional operational guidelines which auditors can use when designing audit programs. One of the key features of SAS 99 is a list of fraud risk factors that every auditor should consider during an audit. Applying these risk factors to the development of the audit program enhances fraud detection, obviously, by focusing audit resources on areas with the greatest risk of fraud.

The International Federation of Accountants (IFAC) addressed one of the most important issues facing auditors today—the responsibility for detecting fraud—by releasing an International Standard of Auditing (ISA) entitled *The Auditor's Responsibility to Consider Fraud in an Audit of Financial*

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Statements (ISA 240). It states that while the primary responsibility for the prevention and detection of fraud rests with those charged with governance and management of the entity, auditors should be alert to risks of material misstatement due to fraud and are required to assess any such risks encountered during the course of an audit. Auditors are also required to respond to the assessed risk by such actions as testing the appropriateness of journal entries, reviewing the accounting estimates for biases, and obtaining an understanding of the business rationale of significant transactions that are outside of the normal course of business for the entity.

All of the standards stress the duty of auditors to plan and conduct audits in a manner that reasonably ensures that financial statements are free from errors or serious misstatements. They also charge audit with the responsibility of evaluating the organization's controls and the adequacy of management actions to identified weaknesses. The standards require that auditors plan and perform audits in a manner that reduces the risk of fraudulent activities going undetected. However, the standards do not place responsibility for the deterrence, prevention, or detection of these irregularities solely on audit. It remains management's responsibility to oversee the operations of the company and to deter fraud. This situation must be explained in any corporate statement on fraud and clearly communicated to all levels of the organization. The best solution to fraud deterrence and detection is a partnership among management, internal and external audit, and fraud investigators—with everyone working together in a complementary manner to deal with fraud.

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Initially, it may be difficult to determine if a fraud has occurred. Something that starts out as an audit may uncover possible criminal activities and become a fraud investigation. Auditors should always be aware of the possibility of fraud and know when or if to call in fraud investigators or police.

Exhibit 1.2 can be used by audit to determine whether an allegation should be referred to fraud investigators or police. It can also be used by audit in developing a fraud policy to map out when audit will be involved and when allegations will be handed over to investigators or police.

How does an organization develop a fraud resistant culture?

The best method to avoid fraud is to stop it before it occurs—through ethics and fraud awareness training. To do so, not only control but also alertness must be created at all levels of the organization. However, fraud prevention must be commensurate to the risk. Care must be taken to avoid creating an atmosphere of distrust and paranoia by overemphasizing fraud deterrence.[7] A corporate ethics program helps to lay a clear foundation for all aspects of employee actions, not just those related to fraud. In recent years, ethics programs have become more common and have demonstrated

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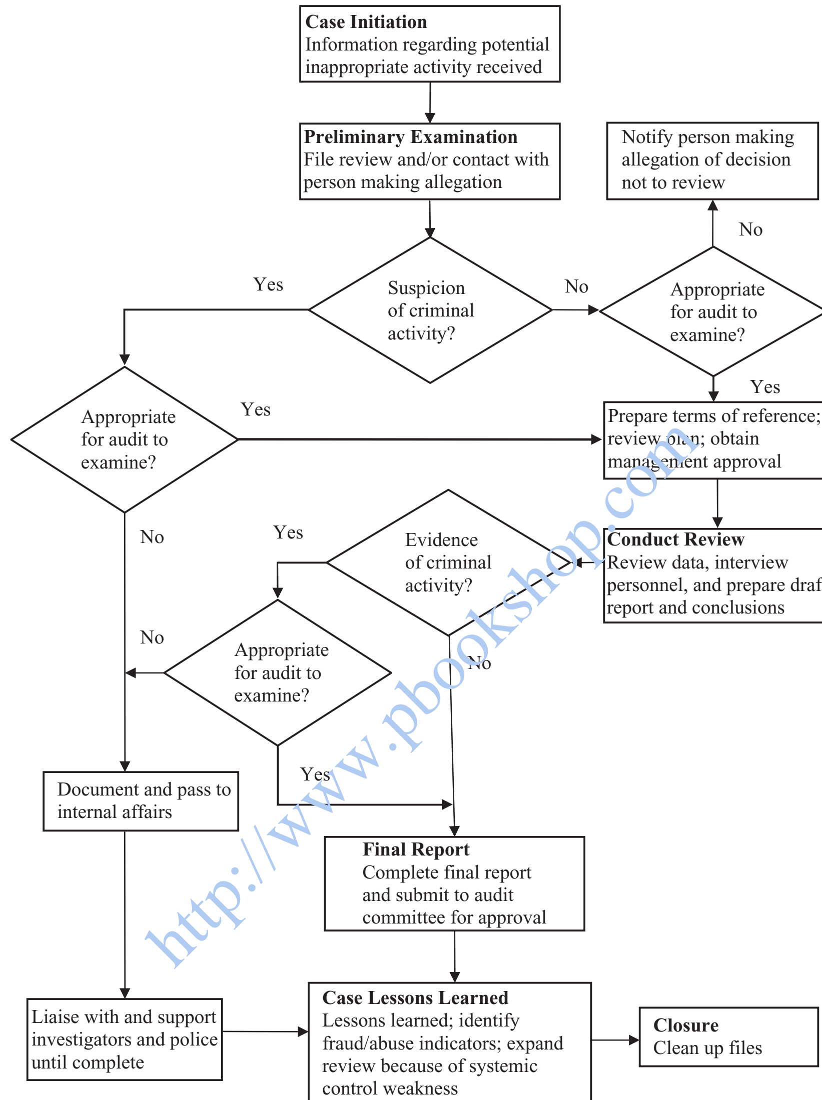

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EXHIBIT 1.2 **Allegations Flowchart.**

considerable value in shaping and guiding employee behavior. An existing ethics program, expanded to include fraud awareness and deterrence measures, is an excellent method of reducing losses to fraud. Although experts warn that ethics programs may seem like an obvious way to combat corruption, organizations simply going through the motions of ethics

P1: OTA/XYZ P2: ABC
c01 JWBT037-Coderre January 19, 2009 16:13 Printer Name: Yet to Come

training and not embracing the real spirit of the effort are just wasting their time.

It is important to understand the underlying cause of the employee behavior, the fraudulent activity, when developing fraud deterrence policies. Often theft is a reflection of how management is perceived by the employees. Any company policy on fraud should be communicated in a manner that stresses the positive. Sanctions must be clearly stated and uniformly enforced. It must be apparent that the rules apply to everyone. The policy must be supported and encouraged by all levels of management, and senior management especially must demonstrate the highest level of integrity—not only following the rules, but appearing to do so. Nothing can foster an attitude that "fraud is acceptable" as quickly as senior management's disregard for financial rules and regulations. The fact that a questionable act is "good" for the company or only affects the competition is not an adequate excuse. Such behavior by senior management may contribute to other types of fraud being considered equally acceptable by employees. Acceptance of any type or level of questionable activity may be seen as a green light to all sorts of activity, including fraud.

By creating a fraud-resistant culture, management can avoid not only the associated monetary losses but also the negative side effects, such as adverse publicity, poor employee morale, and possible loss of goodwill. Fraud can be a public relations nightmare—witness the negative effect that the conviction of a president of the United Way of America had on public and corporate donations, or the negative publicity experienced by Martha Stewart.

A company policy or program emphasizing the general application of ethical standards and practices can help to prevent fraud. A fraud awareness program, mandatory screening of job applicants, and a corporate fraud policy then will complement it.

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What Is a Fraud Awareness Program?

A fraud awareness program demonstrates to all employees that the company considers fraud a serious issue. It should cover the company's prevention measures and tell employees what they should do if they are concerned about possible fraudulent activities. It must be clear that fraud will be dealt with swiftly and fairly. A well-constructed fraud awareness program will discuss how, when, and to whom to report possible fraudulent activities. Employees who are aware of the company policy, know the rationale for it, understand the damaging implications of fraud, and know what to do if they suspect fraud are the best line of defense against such activities.

P1: OTA/XYZ P2: ABC
c01 JWBT037-Coderre January 19, 2009 16:13 Printer Name: Yet to Come

Many companies have added fraud awareness training to existing corporate ethics programs, and some package it with counseling or employee assistance programs. A fraud awareness program is a critical step to deterring fraud and helps to ensure that all employees know what is expected of them. By demonstrating that all employees have a role to play in deterring and detecting fraud, and by addressing various types of fraud (including fraud committed by employees and by outsiders), the program fosters confidence and trust.

Screening Job Applicants

Screening job applicants and temporary employees is a simple and effective way to reduce the risk of employee fraud. Such programs ensure that candidates have been honest concerning educational background and employment histories. All education claims and references should be verified and a search conducted for criminal records. It has been estimated that 10 to 25 percent of resumes include serious misstatements. Where not prohibited by law, some companies also require drug testing of temporary employees, vendors, and contractors. The intent is to keep out those who have committed fraud in the past or may be pressured into committing it in future.

A thorough screening program can reduce fraud, help to ensure that properly qualified candidates are selected for the job, and have the added positive effect of reducing the overall cost of attracting and hiring qualified staff. Screening potential candidates also makes it clear to new employees that the company is serious about the importance of honesty and truthfulness, and lets employees know that they are valued and trusted.

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What Is a Corporate Fraud Policy?

One way for an organization to define what constitutes unacceptable behavior and to formalize how fraud investigations will be handled is to have a written fraud policy. A corporate fraud policy formally sets out what an employee is expected to do when he or she suspects that fraud is occurring. It also increases employee awareness of the seriousness of fraud and management's refusal to tolerate such activities. Such a policy is central to any fraud awareness program as it sets the tone for the company and for its employees, demonstrates management's resolve to deter fraud, and formalizes the manner in which the company will handle fraud.

Fraud is committed not only against organizations but also by organizations—or by individuals in an organization—to the betterment of the organization. A strong corporate fraud policy must convey the message

P1: OTA/XYZ P2: ABC
c01 JWBT037-Coderre January 19, 2009 16:13 Printer Name: Yet to Come

that no one has the authority to commit illegal acts on behalf of the company, including fraudulent financial reporting, through which the company may benefit—nor the authority to cover up such illegal acts. The fraud policy establishes a framework for ethical behavior by all employees in all circumstances and details the measures that will be taken to address fraud by individuals inside and outside of the organization. It must also make clear that *any* fraudulent activity will be investigated and the perpetrators prosecuted.

The policy must clearly spell out the procedures to be followed when potentially fraudulent activities are encountered. Such procedures are necessary to ensure the proper handling of possible frauds, to protect employees from wrongful allegations, and to reduce the opportunity for successful litigation by suspects, victims, or witnesses. The procedures reduce the impact of emotions and the opportunity for discrimination, and create an atmosphere of trust by setting the stage for the fair and equitable treatment of all employees.

The fraud policy should be fairly short, simply stated, and contain at least these points:

- A statement of the company's intent to prosecute persons who commit fraud
- A clear statement of who is responsible for the deterrence, detection, and investigation of fraud
- Guidelines and procedures for handling suspected fraud or allegations of fraud
- Instructions on who will be notified at various stages of the investigation of alleged fraud
- Criteria for determining if, and when, legal, law enforcement, and regulatory agencies will be involved
- Guidelines for reporting and publishing the results of fraud investigations.

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A well-written corporate fraud policy acts as a deterrent by demonstrating that management has thought about fraud and has taken action to deter such acts. The policy also assists employees who may be placed in compromising situations by giving them concrete direction and guidance. The policy can help to ensure that all instances of fraud are dealt with in a consistent and nondiscriminatory manner, as well as letting employees know that there will be open and equitable treatment of all allegations of fraud. A corporate fraud policy also aids auditors and fraud examiners by setting out procedures to be followed when allegations or suspicions of fraud arise.

P1: OTA/XYZ P2: ABC
c01 JWBT037-Coderre January 19, 2009 16:13 Printer Name: Yet to Come

Many auditors and fraud investigators find themselves in situations where they are unsure of the next action to be taken, such as whether legal or regulatory agencies should be notified. The corporate fraud policy is the authoritative document on fraud issues, and should be consulted and used as required. Persons investigating fraud will be comforted by the clear statement of the procedures for handling allegations and the investigation of actual fraudulent acts. Also, management can be more confident that the proper steps are being taken and that appropriate authorities notified in a timely manner.

Example of the Main Elements of a Fraud Policy

The senior board of directors wishes to make it clear that (Company Name) has zero tolerance for the commission or concealment of fraudulent or illegal acts. Allegations of such acts will be investigated and pursued to their logical conclusion, including legal action where warranted. All employees are responsible for reporting suspected instances of fraud to their manager.

Management has primary responsibility for the implementation of internal controls to deter and detect fraud. Management is also responsible for referring allegations of fraud to the Chief Audit Executive (or Director of Fraud Investigation, if one exists).

Audit is responsible for monitoring and evaluating internal controls to detect possible weaknesses. The Chief Audit Executive (or the Director of Fraud Investigation) has primary responsibility for the investigation of allegations of improprieties committed by, or against, the company.

During the initial phase of any investigation, the investigators/auditors will protect the reputations of all concerned by restricting access to all information related to the allegations and investigation to those with a legitimate need to know. Where an investigation concludes that a fraudulent activity is "probable," the Chief Audit Executive (or Director of Fraud Investigation) will inform senior management of the nature and possible extent of the activities. The Chief Audit Executive (or Director of Fraud Investigation), with the advice of senior management, will determine whether to inform the legal department, law enforcement, and/or regulatory agencies.

If an investigation determines that fraudulent activities have occurred, the Chief Audit Executive (or Director of Fraud Investigation) is required to inform the head of the legal department, members of the audit committee, and the appropriate law enforcement agencies.

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The company will make all evidence collected during the course of the investigation available to legal and law enforcement agencies and will pursue the prosecution of all parties involved in the criminal activities.

Information on detected fraudulent activities will be published in company newsletters and made available to all employees.

Signed President of (Company Name)

Date

Notes

1. KPMG Forensic, *Fraud Survey 2003*, KPMG Forensic, 2003.
2. Association of Certified Fraud Examiners, *Occupational Fraud and Abuse*, (Austin, TX: Obsidian Publishing Co., 1997).
3. Deloitte Touche Tohmatsu International, *International Fraud within the European Union*, Deloitte Touche Tohmatsu International, 1997.
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6. W. S. Albrecht, E. A. McDermott, and T. L. Williams, "Reducing the Cost of Fraud," *Internal Auditor* (February 1994): 28–34.
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