



Fraud and other corporate malfeasance

Introduction

The Midwest Audit Committee Network is a group of audit committee chairs drawn primarily from public companies headquartered in the Midwest. The fifth meeting of the network was held in Chicago on May 28, 2009, and focused on the role of the board and audit committee in preventing, detecting, and investigating fraud and other corporate malfeasance. Members were joined over dinner by Christine Edwards, from the law firm Winston & Strawn, who further informed the discussion. This document synthesizes key issues that emerged from those discussions.¹

The members of the network present, who sit on the boards of approximately 25 large-, mid-, and small-cap companies between them, were:

- Dave Burritt, Audit Committee Chair, Lockheed Martin
- Howard Carver, Audit Committee Chair, Assurant
- Brenda Gaines, Audit Committee Chair, Office Depot
- Sandy Helton, Audit Committee Chair, Covance
- Olivia Kirtley, Audit Committee Chair, U.S. Bancorp
- Laurette Koellner, Audit Committee Chair, Sara Lee
- George Off, Audit Committee Chair, Telephone and Data Systems
- Rich Roedel, Audit Committee Chair, Brightpoint
- David Schwartz, Audit Committee Chair, Walgreen
- Al Smith, Audit Committee Chair, Simon Property Group

The following members were not able to attend the meeting but took part in post-meeting discussions:

- Blake Devitt, Audit Committee Chair, Baxter International
- Cheryl Francis, Audit Committee Chair, Morningstar
- David Landsittel, Audit Committee Chair, Molex
- Cary McMillan, Audit Committee Chair, Hewitt Associates

¹ VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by members and guests during and after the meeting.



Ernst & Young partners participating in the meeting included:

- Rich Bonahoom, Midwest Accounts & Business Development Leader
- Jon Feig, Fraud and Investigative Dispute Services
- Jim Logothetis, Global Client Service Partner

Executive summary

Members discussed how boards and audit committees prevent, detect, and investigate fraud. The key themes of the discussion are summarized below and in more detail on the following pages:

- **The current fraud landscape** *(Page 3)*

Network members agreed that incidents of fraud and other corporate malfeasance are inevitable, and they expect that the current economic downturn will exacerbate the three primary causes of fraud: pressure, opportunity, and rationalization. While audit committees are most focused on deterring and detecting financial reporting fraud, they are also concerned with third-party fraud, market fraud, and fraud and compliance risks associated with international operations.

- **International risks and controls** *(Page 4)*

Audit committee chairs say that international fraud risks are of particular concern and such risks often increase in direct proportion to the distance from the company's headquarters. Members are concerned about potential violations of the Foreign Corrupt Practices Act (FCPA), given the significant financial and reputational consequences violation incurs. Members agreed that it is important for boards to understand differences in foreign business cultures and to ensure economic value is being provided in exchange for contracted payments.

- **What can boards and audit committees do?** *(Page 5)*

Members stressed the importance of tone at the top in deterring fraud risk and identified several red flags that might indicate deficiencies. For their part, the board must emphasize the code of conduct and send a clear message to employees when fraud is discovered. Members agreed that whistleblower hotlines offer an important glimpse into a company's organization and culture. They also agreed that a robust internal audit function can deliver a favorable return on investment even in a challenging business climate and should therefore be protected.

Network members discussed several practices the board and audit committee can adopt to oversee fraud risks more effectively, including cross-company brainstorming sessions, proactively engaging forensic accountants, informal meetings with the finance group, and board trips and meetings away from the head office. Given that fraud investigations may sometimes be time sensitive, several members said their boards had initiated relationships with outside counsel, even when counsel was not formally retained.



The current fraud landscape

As one member said prior to the meeting, *“I don’t care what controls you have in place, if you have more than two people that want to commit a fraud, they’re going to do it.”* Moreover, the sums lost can be considerable. In its 2008 report, the Association of Certified Fraud Examiners (ACFE) estimated that fraud losses would account for approximately \$994 billion of the then-projected 2008 US gross domestic product,² given that, on average, “U.S. organizations lose 7% of their annual revenues to fraud.”³ Clearly, this is an issue that deserves board attention.

Members’ concerns are not limited to fraud, and meeting participants were quick to point out that other *“malfeasance can have significant consequence as well.”* One member shared, *“In one instance, we had a malfeasance issue where neither party did what they did for money. Two employees down in the bowels of the company did something because they wanted to be recognized for a good job. It wasn’t outright fraudulent behavior, but we ultimately ended up spending \$20 million investigating it.”*

The risk of fraud and other malfeasance is increasing

While members agreed that fraud is inevitable, they also agreed that *“as times get hard, fraud goes up.”* In describing the “fraud triangle,” the ACFE notes, “Three factors are generally accepted as being necessary for fraud to occur: pressure, opportunity, and the ability to rationalize illegal behavior. Unfortunately, the presence of each of these factors may rise in periods of economic hardship.”⁴ One member observed that *“when the music stops, that’s when things are uncovered.”* Another member noted, *“The [Bernard] Madoff scandal teaches us that as the economy gets worse, things are easier to find because fraud is harder to hide.”*

Recent data support member experience. In an ACFE survey of more than 500 certified fraud experts conducted throughout February and March of 2009, more than half (55%) of those polled said they had seen an increase in fraud over the past year.⁵

Where is the board focusing its attention?

Participants identified and prioritized four primary areas of fraud concern for the board:

- 1. Finance and reporting.** While members agreed that no fraud is unimportant, they said financial-reporting fraud poses the most significant threat to the company. *“We’re definitely focused the most on financial fraud. That’s what worries me the most because the consequences are enormous. If someone walks away with some inventory in Dubai, it isn’t good, but the implications of financial fraud are catastrophic.”*
- 2. International operations.** Chief amongst international concerns are possible violations of the FCPA: *“As a director, FCPA is what leaves me gasping for breath ... You feel so vulnerable. Even if*

² Based on a review of 959 cases of occupational fraud cases. Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: Association of Certified Fraud Examiners, 2008), 4. Available at <http://www.acfe.com/documents/2008-rttn.pdf>.

³ Ibid.

⁴ Association of Certified Fraud Examiners, *Occupational Fraud: A Study of the Impact of an Economic Recession* (Austin, TX: Association of Certified Fraud Examiners, 2009), 6. Available at <http://www.acfe.com/documents/occupational-fraud.pdf>.

⁵ Ibid., 4–5.



you have good controls, something often happens. It might be a small incident, but it carries big consequences, so we are focusing a great deal of attention on that.” This topic is explored in more detail in the following section, “International risks and controls.”

- 3. Third-party fraud.** *“The concern around third-party risk is much higher, if only because there are more third-party alliances, collaborations, and joint ventures being done outside companies’ headquarters and to a much greater degree than there were ten years ago.”* Members also agreed that *“arrangements between buyers and suppliers [are] a big fraud risk.”* Added another member, *“We proactively began reviewing our suppliers and vendors a few years ago. We’ve found some really bad stuff, and the [rate of fraud] is going up.”*
- 4. Market fraud.** Christine Edwards suggested that insider trading should be included on this list: *“I have been surprised by how little businesses have been focusing their training efforts on insider trading issues. Companies that are not in financial services need to be aware of this, too.”* Ms. Edwards also called attention to heightened risk of antitrust activity: *“There is a new rigor about the antitrust division as they watch closely for concentrated markets, price fixing or price signaling. Governance issues will be targeted, such as cross membership on boards.”*

International risks and controls

Members agreed that *“an extra emphasis on fraud is needed the farther away from headquarters you get.”* Adding to the challenge, there is no accurate way to predict where fraud might occur: *“We had to go through a restatement because of an incident at an international location where we never thought we would have problems.”*

FCPA is “a huge concern”

In the mid-1970s, in response to Securities and Exchange Commission (SEC) investigations, “over 400 U.S. companies admitted making questionable or illegal payments in excess of \$300 million to foreign government officials, politicians, and political parties.”⁶ In response, Congress enacted the FCPA in 1977 to “bring a halt to the bribery of foreign officials and to restore public confidence in the integrity of the American business system.”⁷ The FCPA generally prohibits US companies and citizens, foreign companies listed on a US stock exchange, or any person acting while in the United States from corruptly paying or offering to pay a foreign official to obtain or retain business.⁸

Network members report that they have been increasingly mindful of their obligations under the FCPA in recent years, recognizing that global expansion presents *“enormous opportunity matched by an enormity of risk.”* Several members said that the current economic crisis has only heightened their awareness of FCPA and has pushed them to *“grab the bull by the horns”* and ensure that their companies *“are all over the risks associated with foreign corruption.”*

⁶ Cassin Law, “About Foreign Corrupt Practices Act,” <http://www.cassinlaw.com/fcpa.html>.

⁷ Ibid.

⁸ Foley & Lardner, “The FCPA Explained,” <http://www.fcpaenforcement.com/explained/explained.asp>.



Certainly, “companies cannot afford to ignore the obligations associated with the FCPA and other anti-bribery laws ... Companies and their boards that do not consider their corporate and individual vulnerability to FCPA enforcement are taking unnecessary risks.”⁹ As SEC chairman Mary Schapiro said, “FCPA violations have been and will continue to be dealt with severely by the SEC and other law enforcement agencies. Any company that seeks to put greed ahead of the law by making illegal payment to win business should be aware that we are working vigorously across borders to detect and punish such illicit conduct.”¹⁰ However, as one member observed, *“No matter how hard you try, it doesn’t take a lot to undermine all the processes you’ve put in place and have significant financial and reputational repercussions for the company.”*

Recognize cultural differences

Members agreed that it is important to understand the different cultural norms that exist in various international locations. As Ms. Edwards pointed out, *“We have a vibrant civil justice system here in the United States, but that is certainly not the case in other countries.”* A member noted, *“Ofentimes it isn’t a matter of ethics; in many countries this [behavior] is the ethic.”* As a result, *“you can go through a period of not even knowing you’re exposed, because the local management doesn’t even see something is wrong.”*

One member reported: *“We caught email traffic in [Asia] asking what to do with [some] money if it was not meant to go to foreign officials. They thought they were being honest in raising this issue because that is the [business] culture over there. After you pick your jaw up off the table, you need to go in and explain things in a way they will understand it culturally and train and ingrain those ethics repeatedly.”*

Given the differences across foreign cultures, meeting participants emphasized the benefit of testing transactional activity. In many cases, this involves reexamining foreign contracts for payments not associated with clear economic value. One member commented, *“We look at contracts on a selective basis, particularly those that appear to be unusual. We have uncovered some things that are [improper] that were within the contracts of [some of our foreign locations].”* Jon Feig of Ernst & Young’s Fraud and Investigative Dispute Services commented, *“Most people are concerned about controls rather than transactional testing. However, in heightened areas of risks, it can be very effective in uncovering inconsistencies. I don’t know why audit committees don’t ask for that more often.”*

What can boards and audit committees do?

After identifying their primary areas of concern, members delved deeper into ways the board and audit committee can most effectively deter, detect, and investigate fraud within their companies.

Tone at the top

Members stressed the importance of the words and actions of the board and senior leadership in minimizing the likelihood of fraud: *“There is nothing more important than tone at the top. We have an obligation to*

⁹ Ernst & Young, “Senior executives see jump in anti-corruption enforcement,” press release, May 14, 2008. Available at <http://www.ey.com/GL/en/Newsroom/News-releases/Media---Press-Release---Senior-executives-see-jump-in-anti-corruption-enforcement>.

¹⁰ US Securities and Exchange Commission, “SEC Charges KBR and Halliburton for FCPA Violations,” press release, February 11, 2009. Available at <http://www.sec.gov/news/press/2009/2009-23.htm>.



get the message out and cascade it down.” Members highlighted several additional ways companies can and should be addressing tone at the top:

- **Send a clear message.** Members agreed the board needs to “take firm, appropriate action as soon as [fraud] is discovered.” One member said, “Every time there was an incident of fraud, we published an ‘ethics moment’ in the company newsletter that described how we came across it, what we did, and what we found. It wasn’t swept under the carpet. We put a name and a face to all of it, which really helped humanize fraud.” Most members agreed that a “zero tolerance policy” is often best.
- **Emphasize the code of conduct.** One member reported that “people who are constantly reminded of the code of conduct [behave more ethically].” Added another member, “It might not stop everyone, but if you can raise that cultural awareness of fraud, it gets everyone to raise their hand. It all starts at the top.”
- **Have the board visit overseas locations.** “Traveling and ‘feeling’ management is always a good thing. If you spread that practice, it gets more people touched, and I think that’s an appropriate role for the board. It sends an important message throughout the company that the board thinks these issues are significant.”

Internal audit

Many companies have downsized in recent months. Experts note that “paradoxically, it is these organizations – those that are trimming costs and struggling to stay afloat – that most likely need a strong system of anti-fraud controls. Employees who remain after a round of layoffs often experience decreased morale, which – when combined with the added job responsibilities of former colleagues, fewer formal controls, and increased pressure to perform – can lead to the perfect storm for fraud.”¹¹

That being the case, members said that now is not the time to be cutting back on internal audit staff. In fact, several members pointed out that internal audit “more than pays for itself” through its fraud mitigation activities: “We’ve more than recovered our normal cost of internal audit with how much we have uncovered through proactive investigations.”

Members agree that internal audit has a particularly significant role on the international front: “You want to make sure internal audit is touching all of your businesses. We operate in over 30 countries and need to make sure someone is kicking the tires frequently.” Members noted that international audits often present unique language and cultural challenges. They described two alternative staffing models:

- **Company auditors only, to ensure consistency.** “I feel strongly that [the international internal audit team] should be internal. You’re trying to convey the policies and procedures of your company, and it’s hard to impart that tone in a foreign country if it’s not your [own] people.”
- **Co-sourcing, to bridge cultural gaps.** Many companies supplement their own internal audit staff with local professionals from accounting firms and other third-party providers: “I think the co-

¹¹ Association of Certified Fraud Examiners, *Occupational Fraud: A Study of the Impact of an Economic Recession*, 12.



sourcing model is best. It's important to understand the business environment and have language capabilities, and co-sourcing allows you to do that."

Red flags that warrant further investigation

- **Management arrogance.** *"I want someone talking to me, not talking down to me. There are some CEOs who think they are the king ... The worst thing you can do is [blindly] trust them."*
- **Pressure to hit financial targets.** *"There's an understanding that you budgeted; now how are you going to get there? Sometimes this leads to too much pressure to close the book on the right numbers."*
- **Internal audit recommendations that have been ignored.** *"If management has been ignoring the findings of internal audit, that is a big red flag for me."*
- **Troubling whistleblower hotline trends.** *"The whistleblower line has been the best source of patterns or indications that we have a fraud issue. It points us in a direction and tells us we have a more systemic issue we need to address."*
- **Turnover in staff responsible for internal controls.** *"Turnover in the internal controls group makes [the function] more susceptible to fraud. You can also catch a great deal in exit interviews."*
- **Differences in company culture that result from mergers and acquisitions.** *"M&A often increases the risk of fraud because you're acquiring another culture."*
- **Management reluctance to investigate fraud allegations.** *"We discovered an incidence of fraud, and management was reluctant to move on it; it took several weeks for them to make a decision. When that happens, [it] makes you wonder where else that is going on."*
- **Unexpected, early departures of senior executives.** *"We had a senior-level executive leave after only being with the company for a short period of time. I found out through a third party later on that this person had actually left because of [concerns with] the CEO."*

The whistleblower hotline

Section 806 of the Sarbanes-Oxley Act requires companies to establish and maintain a whistleblower hotline for the reporting of fraud. While members say employees often misuse the whistleblower hotline, particularly to vent about human resource issues, most also say that the whistleblower hotline is a valued mechanism for deterring fraud.



The ACFE reports that tips have historically been the most common means of detection for publicly traded companies, and its 2008 study suggests that the percentage of fraud discoveries attributed to tips in 2008 (over 46%) is quite a bit greater than in years past.¹²

Whistleblower reports are directed to the internal audit function, general counsel, a compliance officer, or an independent screening firm. In pre-meeting discussions, members agreed that whistleblower hotline activity analysis is one of the most useful fraud indicators at that board's disposal: *"What we've seen as one of the best early-warning signs are the 800 hotlines. There are all these eyes and ears in the organization saying, 'Something doesn't smell right,' and that raises issues. Some of the [tips] lead to nothing, and some of them uncover bad stuff."*

The role of the full board

The full board has a significant role to play in monitoring their company's exposure to fraud and other corporate malfeasance. Whether or not the audit committee is directly involved, members highlighted several key ways board directors can better oversee fraud risk:

- **Encourage management to organize cross-company brainstorming sessions.** Several members described as a best practice *"bringing together groups of people from across the company and brainstorming where fraud can occur."* One member noted, *"When you get everyone in a room together and talk about fraud, it really gets the juices flowing and helps get people thinking about it."* Another member said teams should discuss *"not just what is happening, but where it's happening. [This activity] helps us to focus our [fraud risk] assessment."*
- **Establish separate risk and controls group to address international fraud risk.** *"We've put together a separate risk-and-controls group [for] every country we've [entered]; we send that group in with [local] management to make sure the same sets of controls, processes, [and] code of conduct are being enforced. We then send internal audit in a few months later to follow up."*
- **Hold local leaders accountable.** *"Whenever we uncover fraud, we fly the [business unit leader] to the headquarters, regardless of where they are located internationally. Even if it's just for a 15-minute presentation, we still make them come [to explain to the board]. After that, incidents always get fixed, and the [business unit leaders] never come back."*
- **Ensure familiarity with the code of conduct.** *"We have courses around our code of conduct and ethics training that everyone attends when they first start working at our company. We also have a mandatory refresher meeting once a year. We make everyone go through it, and it's very helpful."*
- **Proactively engage forensic accountants.** *"We've beefed up forensic accounting to try to [proactively] catch some of the financial issues that may crop up as a result of economic pressures."* Another member added, *"The focus of forensic accounting is determined by our risk assessment. It's helped us focus in on areas where we felt we were more exposed."*

¹² Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud and Abuse*, 18.



- **Invite selected employees to board dinners.** *“At every board dinner we bring in three or four people from various business units to get to know the board, let them ask questions. Having that interaction is very helpful. [We] pick up on little things [about the corporate culture] that sometimes lead to big things.”*
- **Expand touchpoints with employees at all levels.** *“We routinely meet with people outside the finance organization. It’s important to look at the whole business and see who you’d like to have a private conversation with to understand what’s being done and how it’s all cascading down.”*

Audit committee duties

Members agree the audit committee can also play a significant role in minimizing the opportunities for fraud. Several specific practices emerged:

- **Holding informal meetings with the finance group.** *“Whenever we have a board meeting away from the headquarters, the audit committee always has breakfast with the finance team. Every audit committee member shows up, and they’re really good and insightful meetings.”* Another member added, *“I’ve found the informal meetings very helpful for getting a feel for the capabilities and competence of those groups, and also having them better understand our role as an audit committee.”*
- **Being available at all times.** *“I know an audit committee chair who tells all members of management, ‘I want you to know that as audit committee chair, I am always available. Here is my email, home number, cell phone number, etc. I expect you to call me if something comes up.’ We need to set up that expectation. Make them understand that they will not be bothering us. Make sure to say it often.”*
- **Audit committee chair trips.** In their capacity as audit committee chairs, some members described the value of trips outside headquarters: *“I go abroad routinely to visit offsite locations. During one of these visits, I attended a global presentation, and the accounting treatment [the senior finance executive] was speaking about was written nowhere on this planet. I went to the CFO afterwards and said, ‘We have a problem.’ We launched an investigation, did a restatement, and were able to do all of it if fairly below the radar. It helps to go abroad and see these things for yourself.”*

Investigating fraud

If fraud is discovered in the organization, or there is reason to believe that fraud has occurred, a chain of events is set in motion rapidly, with potentially serious ramifications internally and externally. Consequently, *“if there is an allegation where senior management is involved, or if there is any potential impact on the financial statements, the audit committee and board need to become actively involved.”* Another member said, *“If you have an allegation [of] fraud in a particular group, management might take the first crack at it, but [the board and audit committee] better not be far behind.”* Ms. Edwards concurred, saying, *“At what point do you [as a director] get involved in [a fraud] investigation? The answer: five minutes into it.”*



Some members noted that technology can help investigators uncover fraud. In particular, email logs may contain “smoking guns,” and data mining practices may reveal patterns or raise red flags. One member said “data preservation [policies] are huge,” while another intended to “find out what our data retention plan is.”

Members disagree on the need for the board to retain independent outside counsel, whether proactively or immediately upon a fraud allegation.

- **Exercise the audit committee’s right to independent counsel:** *“Every audit committee should have a separate counsel. I insist on that before I go on a company board.”*
- **Be cautious about using outside counsel:** *“You need to think it through thoroughly and carefully before you retain outside counsel. In a lot of organizations, it can be difficult because it sends a message through the company, and it vibrates.”* Added another member, *“If you do an investigation, do you want it to be little ‘i’ or capital ‘I’? Once you get this started, it becomes a much bigger issue.”*
- **Keep the option of independent counsel available:** *“We pick a firm beforehand and have a conversation with them to make sure they’re qualified. We keep them on call should we ever need them.”*

Members recognize that the audit committee’s role in special investigations is complicated and requires more thought: *“This is one area of risk that the audit committee has full responsibility for. All the aspects of the investigation are extremely complex. This is not a two-minute discussion.”*

Conclusion

Midwest Audit Committee Network members agreed that directors need to be particularly mindful of fraud risks during periods of change. In the end, though, members acknowledge that fraud is a human behavior: *“As board members, we have to be cognizant that if we’re dealing with people who are long on integrity and tone at the top, a lot of these issues will be taken care of.”* Another member observed, *“We can talk all we want about fraud and procedures. However, if we hire the right people, and retain the right people, none of this is going to happen. We need to spend more time developing people and keeping [integrity] the top-of-the-mountain focus. It’s all about the people.”*

The views expressed in this document represent those of the Midwest Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the US member firm of Ernst & Young LLP.

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Appendix: Questions on fraud and other corporate malfeasance for audit committees to consider

- ? How has the economic crisis affected your perception of fraud risk at your companies?
- ? What steps is your committee taking to mitigate fraud risk? How do these differ from the actions you take in a less extraordinary economic environment?
- ? What types of fraud are of greatest concern to the board and the audit committee? With what other malfeasance should the board concern itself?
- ? What specific challenges do boards and management teams face in complying with the FCPA?
- ? What steps has your company been taking to address the fraud risks associated with foreign operations? How well does the board understand its legal obligations under the FCPA?
- ? How has management adapted internal controls in the face of staffing reductions? What impact might this have on Section 404 compliance?
- ? What role should internal and external audit play in fraud prevention, detection, and investigation? How has this role changed in the last twelve months?
- ? How do you, as audit committee chair, contribute favorably to tone at the top?
- ? Under what circumstances should the audit committee participate in fraud investigation? What procedures should be established proactively?
- ? Who manages the whistleblower process? Does the audit committee see all whistleblower complaints, or are they filtered in some way (by relevance, materiality, type, etc.)? How can the audit committee evaluate the effectiveness of the whistleblower hotline?
- ? How might audit committees work with the SEC and other government enforcement agencies to improve transparency around financial statements and decrease risk of fraud? What do boards expect of these government agencies?
- ? What is the future of fraud detection? Do you see an opportunity for more analytic rigor in your board and audit committee's approach to assessing fraud?
- ? What information does the board need to oversee fraud prevention procedures effectively? What structures are necessary (e.g., quarterly reviews, etc.)? What other information or structures would be helpful?