



Fraud and other corporate malfeasance

On September 15, 2009, members of the Southeast Audit Committee Network (SEACN) met in Atlanta for the network's 14th meeting. Members discussed the impact of the current economic environment on the risk of fraud and other corporate malfeasance. Guests for the meeting included Jeff Taylor, Ernst & Young's Americas Leader for Fraud Investigation and Dispute Services (FIDS) and a former US attorney for the District of Columbia, and Steve Kuzma, Ernst & Young's Americas Chief Operating Officer for FIDS.

In a separate, unreported session, members discussed the shifting corporate governance landscape over dinner with Les Brorsen, Americas Director of Government Relations at Ernst & Young.

Collectively, members of the network participating in the meeting sit on the boards of more than two dozen large-, mid-, and small-cap public companies:

- Eddie Adair, Audit Committee Chair, Tech Data
- John Farrell, Audit Committee Member, Lender Processing Services
- Doug Ivester, Audit Committee Chair, SunTrust Banks
- Andy McKenna, Audit Committee Chair, AutoZone
- George Minnich, Audit Committee Chair, AGCO
- Dean O'Hare, Audit Committee Chair, H. J. Heinz Company
- Tom Presby, Audit Committee Chair, World Fuel Services and Invesco
- Dave Rickard, Audit Committee Chair, Harris Corporation
- Jim Robbins, Audit Committee Chair, DSW
- Erik van der Kaay, Audit Committee Chair, RF Micro Devices
- Edwina Woodbury, Audit Committee Chair, R. H. Donnelley

Ernst & Young was also represented by:

- Steve Konenkamp, Southeast Assurance Managing Partner
- Chuck Seets, Principal

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. However, Messrs. Kuzma and Taylor have given permission for their comments to be attributed. Quotes in italics are drawn directly from comments made by participants during the meeting.



Executive summary

Members focused on three themes related to the risk of fraud and other corporate malfeasance in the current economic environment. These themes are summarized below and developed in more detail on the following pages:

- **The current fraud landscape** (*Page 2*)

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 forces that lead to fraud: pressure, opportunity, and rationalization. Despite these expectations, members reported that they have not yet seen an increase in major fraud, but rather “*penny-ante fraud*.” Members and their guests said investigation and prosecution of fraud by the Department of Justice (DOJ) and the Securities Exchange Commission (SEC), particularly for violations of the Foreign Corrupt Practices Act (FCPA), are likely to increase.

- **International operations and the FCPA** (*Page 4*)

Members are particularly concerned about potential violations of the FCPA, given the significant financial and reputational consequences of even immaterial violations. Members identified several ways boards and audit committees can address the risk of international operations fraud, including recognizing cultural differences, setting clear expectations, establishing a zero tolerance policy, and rotating foreign leadership.

- **Oversight of fraud prevention, detection, and investigation** (*Page 6*)

Members stressed the importance of good tone at the top in deterring fraud and highlighted several ways to ensure it is reinforced appropriately. Members agreed that the internal audit function is critical to assessing fraud risk and acting as a deterrent. They also discussed the advisability of protecting internal audit resources from the cost cutting proposed by many companies in reaction to the current economic situation. Members noted the audit committee’s important role in identifying areas of vulnerability to fraud and agreed that whistleblower hotlines offer an important view into a company’s organization and culture. Finally, some members discussed the audit committee’s involvement in high-level fraud investigations and the potential value of keeping independent outside counsel on retainer to ensure a speedy response to serious allegations.

The current fraud landscape

As one member said prior to the meeting, “Well-designed fraud is virtually impossible to spot. At the end of the day, we’ll still have fraud because it’s impossible to design any system that’s completely foolproof.” 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,¹ given that, on average, “U.S. organizations lose 7% of their annual revenues to fraud.”²

Members anticipate increases in fraud, although most have not yet seen significant instances

Mr. Taylor told members, *“It is the perfect storm for fraud right now.”* 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.”³ Mr. Kuzma reported that *“empirically, we are seeing that fraud is on the rise globally.”* Recent studies provide supporting data. 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.⁴

While acknowledging these reports, most members reported that they have not been seeing a significant increase in major fraud: *“As a matter of common sense, we think it’s likely that fraud activity will go up because of the economy. I say ‘common sense’ because I haven’t actually seen much of an increase personally.”* Another member said, *“We’re looking hard and not finding much.”*

Some members indicated that they have seen a rise in minor, low-level fraud: *“I’ve seen more instances of penny-ante fraud recently. More expense reports are coming to light and that sort of thing.”* Members pointed out that these instances of fraud might be coming to light because internal audit has been instructed to look harder: *“We’ve challenged internal audit to scrub a little deeper, and I think that’s most likely why we’re seeing more being uncovered.”* Another member remarked, *“When the tide is lowest, that’s when there are more rocks exposed.”*

Members report that financial statement fraud continues to be a focus for audit committees: *“If an organization is under a lot of pressure to cut costs, then one area for consideration is what costs ultimately get capitalized. I think financial statement fraud and other major fraud has a potential to increase. I think my CEO is great, but we have a job to do, and we need to monitor [for fraud more closely] closely.”*

Members point out that malfeasance is also a concern. As one member remarked, *“We’ve found that if there’s any looseness in the rules, people will take advantage of that. It’s not always fraud. People under pressure will take advantage of loose controls wherever they can.”*

Members prepare for enhanced regulatory enforcement

Coinciding with predictions of increases in fraud and other malfeasance is an increasing probability of investigation and prosecution. According to the *National Law Journal*, “The Obama administration is

¹ 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>.

² Ibid.

³ 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>.

⁴ Ibid., 4–5.



dramatically beefing up the fraud section of the U.S. Department of Justice’s Criminal Division as it tries to add muscle to back up its rhetoric about cracking down on ... corporate fraud.”⁵

Mr. Taylor told members, *“The DOJ expects there to be a lot of fraud out there. The department may seem like a sleeping bear right now because we haven’t seen a groundswell of prosecutions just yet – the exception being FCPA – but over time, the increased resources targeted at fraud investigations will lead inexorably to more prosecutions. In addition, the SEC, seeking to restore its reputation, will be looking to bring high-profile actions against corporate and individual violators.”*

International operations and the FCPA

In the mid-1970s, in response to 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 paying or offering to pay a foreign official to obtain or retain business in a wrongful manner.

The SEC and the DOJ work together in the enforcement of the FCPA: “The Department of Justice is responsible for all criminal enforcement and for civil enforcement of the antibribery provisions with respect to domestic concerns and foreign companies and nationals. The SEC is responsible for civil enforcement of the antibribery provisions with respect to issuers.”⁸ Experts caution that “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 Members acknowledged this reality and expressed heightened concern about the FCPA.

Network members reported that they have been increasingly mindful of their obligations under the FCPA in recent years, especially given the increasing regulatory actions and the high costs of investigations: *“We had an instance where the bribes paid by the foreign operation were [a few thousand dollars,] but the cost to the company was ultimately \$2 million.”* Several members said that the current economic crisis has only heightened their awareness of FCPA and has made them realize that *“the audit committee needs to revisit the risks associated with international business.”* Another member observed, *“a fresh look at fraud risk in [foreign operations] is worth doing in this environment.”* However, one audit committee chair pointed out that the task is daunting: *“Trying to interpret FCPA guidelines is scary. Understanding those guidelines and all of the implications has been a real challenge for us as an audit committee.”*

⁵ Mike Scarcella, “DOJ readying fraud attack,” *National Law Journal*, August 10, 2009. Available at <http://www.nacdl.org/public.nsf/whitecollar/wcnews267?OpenDocument>.

⁶ US Department of Justice, “Foreign Corrupt Practices Act: Antibribery Provisions,” <http://www.usdoj.gov/criminal/fraud/docs/dojdocb.html>.

⁷ Ibid.

⁸ Ibid.

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>.



Fraud considerations in international operations

- **Set clear expectations.** *“International ethics training is critical. Preaching this education concept is important as well. We had a road show and required 100% of people to say they understand our code of conduct.”*
- **Have a zero tolerance policy.** *“Having good examples of people being ‘strung up’ for doing the wrong thing is important. [You] need to make sure you have zero tolerance for fraud violations.”*
- **Rotate foreign leadership.** *“We found that management rotation internationally is very helpful. We also rotate the finance staff. They are hired by the headquarters, and they always report back to the headquarters.”*
- **Let foreign units know the audit committee is watching.** *“If you have some concerns about one of your foreign operations, you should ask internal audit to tell the country head that the audit committee is going to be paying particular attention to their next report.”*
- **Have English-speaking managers.** *“It’s important that the [foreign] manager speaks English so the message is received clearly. You should also make sure the code-of-conduct message gets across in the native language as well.”*
- **Reconcile local statutory accounts with US accounting records.** *“We required a reconciliation of our local statutory books to our US GAAP records, and it was amazing what we found – lots of sloppy practice and in some cases deliberate gamesmanship. Understanding those different statutory issues is very important.”*
- **Reinforce business ethics to third parties.** *“We distribute a letter to our overseas vendors emphasizing our code of conduct, so we actually go outside the company with our ethics.”*
- **Integrate a newly acquired company quickly.** *“When we acquired a foreign company, we made sure to do ethics training with the people in the new company. You better do it quickly, though, because they’re your responsibility as soon as the deal is done.”* Mr. Taylor recommended members review the DOJ’s guidance to Halliburton on pre-acquisition due diligence.¹⁰

Members said that they have particular questions and concerns about self-reporting: *“With FCPA, we’re looking harder for [fraud] and seeing it a lot more, and the real challenge we’ve discovered is self-reporting. If you find something small, what do you do?”* A number of members are of the opinion that although the FCPA was designed to deal with major corruption in large contract cases, it is being used excessively, and they feel that Congress ought to review the law to ensure that governmental resources are focused on the most important cases.

¹⁰ See, for example, Morgan Lewis, “Recent DOJ FCPA Opinions Provide Guidance on Preacquisition Due Diligence and Promotional Expenses,” *Litigation LawFlash*, July 28, 2008. Available at http://www.morganlewis.com/pubs/LIT_PrecquisitionDueDiligence_PromoExpenses_LF_28jul08.pdf.



Oversight of fraud prevention, detection, and investigation

Overall, members agreed that the full board and audit committee can play a significant role in minimizing the opportunities for fraud. A 2008 report on fraud released by the Institute of Internal Auditors, the American Institute of Certified Public Accountants, and the ACFE described a good approach: “An audit committee of the board that is committed to a proactive approach to fraud risk management maintains an active role in the oversight of the organization’s assessment of fraud risks and uses internal auditors, or other designated personnel, to monitor fraud risks.”¹¹

Tone at the top

Members noted that good tone at the top is a critical and positive element in fraud mitigation. One audit chair remarked prior to the meeting, “I think it’s the audit committee and the board’s responsibility to make sure tone at the top is constantly being reinforced and that when issues do come up, appropriate actions are taken so that people understand that fraud in any form is not going to be condoned.”

One way the board and audit committee can ensure good tone at the top at the board level is by keeping an eye out for red flags that may indicate a fraud risk. For example, members pointed out that *“any time you have an executive team whose high percentage of net worth is tied into the company [stock], we should be very aware as an audit committee.”* Another member cautioned, *“Another red flag is those managers or business units that never miss a projection. If management is never explaining why things are going so well, that concerns me.”*

Members agreed that watching how management handles certain situations is another good way to gauge the quality of tone at the top in a company: *“Having been through smaller investigations a couple of times helps you get a better sense of tone at the top because it allows you to see how aggressively management pursues violations.”*

Members highlighted several additional ways companies can and should be addressing tone at the top:

- **CEO ownership.** *“Getting the CEO to issue strong memos and messages on the code of conduct is a great way to ensure good tone at the top and establish a culture of ethical behavior.”*
- **Clearly defined roles.** *“As directors, we need to recognize that there’s a role for board members and a role for management – and we need to be very clear about what those roles are.”*
- **Comprehensive code-of-ethics training.** *“Code-of-conduct training is key. If you’re not spending big bucks on training, it’s hard to imagine that you have good tone at the top.”*
- **No tolerance for repeat offenders.** *“Set boundaries. I don’t tolerate repeat offenders. If someone needs to be audited twice, I want to see the operational unit head in front of the audit committee to explain.”*

¹¹ Institute of Internal Auditors, American Institute of Certified Public Accountants, and Association of Certified Fraud Examiners, *Managing the Business Risk of Fraud: A Practical Guide* (Institute of Internal Auditors et al., 2008), 12. Available at http://www.aicpa.org/download/audcommctr/Managing_the_Business_Risk_of_Fraud.pdf.



- **Clear expectations.** *“The audit committee shouldn’t be reluctant to express expectations. Don’t underestimate the impact of setting those expectations, either. It feels trite, but outlining those expectations is actually really impactful.”*

Internal audit

Members unanimously agreed that *“internal audit is one of the most effective ways to evaluate risks, and emphasis around this fact is imperative in this environment. A well-structured internal audit program creates an important preventative mechanism.”* Members also pointed out that internal audit can be helpful in exposing areas of weakness in the company: *“I think it’s important for the audit committee to understand where personnel cuts are happening within the company because that heightened pressure can lead to an increase in fraud risk. Internal audit is a great resource to use to monitor that and keep us updated on what’s happening that could weaken our internal controls.”*

Members reported several different ways of handling the internal audit group in the current economic environment:

- **Protect the internal audit function from cutbacks.** *“I think everyone was fearful that there would be significant cutbacks in internal audit, given the recession, but almost every audit committee chair I’ve spoken to says that they told management, ‘Not only don’t you dare cut back on internal audit, but add [more people].’ Another member concurred: “I think we’re actually spending more these days on internal audit.”*
- **Ensure that internal audit can meet its obligations while reducing resources.** *“We’ve had some modest downsizing of internal audit, and it’s just a matter of sitting down and plugging in hours and making sure we have enough people to cover the risks.”*
- **Outsource the internal audit function.** *“At our company, we determined we weren’t getting value for money out of our internal audit, so we decided to outsource the whole thing to an independent audit firm to improve the quality.”*
- **Ensure that expense restraints apply across the company.** *“I see the same expense controls that the rest of the organization has to do being imposed on internal audit. That doesn’t bother me, though. To every life a little rain must fall.”*

One member noted that despite audit committees’ desire to protect internal audit, some functions were volunteering to meet corporate cost reduction objectives: *“Our head of internal audit did not want to fill open positions because he didn’t want internal audit to go to the CEO and be the only ones not willing to make cuts.”* Another member pointed out that internal audit groups can withstand some downsizing post-Sarbanes Oxley: *“Internal audit groups got a bit bloated after Sarbanes-Oxley. You could also argue that if sales are down 20–30%, there’s less to audit and therefore more room for cutbacks.”*

Members agreed that what ultimately matters is that the internal audit group remembers who they work for: *“One of the key risks you need to monitor is making sure that if the internal audit does discover fraud, they bring it directly to the audit committee. A lot are tempted to bring it to senior management, but it’s*



essential they see that link [to the audit committee]. I'm always sure to tell them that they only get one chance to not let something get to us."

Brainstorming to uncover areas of vulnerability

Brainstorming possible fraud scenarios is one way to uncover fraud risks: *"We do a think tank with external audit and internal audit to discuss how management could override internal controls. We ask the internal auditor to approach the CEO and CFO and directly ask them how they would commit fraud at the company."*

Members pointed out that an executive session brainstorming around fraud risk also allows the audit committee chair to utilize the cumulative breadth of experience of the board and management: *"If you have people on the board and audit committee with different backgrounds, it's helpful to have the brainstorm as well. As a result of one director's previous experience, we found we were extremely exposed in one area and had management change the way they operated the business."*

The whistleblower hotline

Section 806 of the Sarbanes-Oxley Act requires companies to establish and maintain a whistleblower hotline for the reporting of fraud. The ACFE reports that tips have historically been the most common means of detecting fraud at 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 Members agreed that the whistleblower hotline is a valued mechanism for deterring fraud, and Mr. Kuzma pointed out, *"Many fraud [investigations] we are brought into come from tips from employees and customers, many through hotlines."*

Recognizing that each company's whistleblower activity will be different, members suggested testing the hotline's effectiveness: *"I have internal audit test the hotline report by making a bogus call to make sure the message gets through. I've done it two times in two different companies – the first time it went through; the other time it didn't."* Another member said, *"I do the same thing, but we have the external auditor test the hotline instead."*

While members note that employees often misuse the hotline, particularly to vent about human resource issues, they also say it can be useful for more than direct reports of fraud: *"The whistleblower hotline gives you a good sense of what's going on in a department. If you get a number of human resource complaints that smell the same, I see that as a red flag. I read the full report to get a feel for what's going on."* Another member said, *"I couldn't agree more. Looking at the full hotline report gives you a good sense of what morale is like. Any audit committee chair who doesn't look at the hotline report 100% is missing a great opportunity to learn more about their organization."* Still, some maintain that a pre-screened report is enough: *"I get a filtered report because any time I've looked at the full report, it has never contained anything that's helped me as an audit committee chair."*

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



Regardless of what form the hotline report ultimately takes, members agreed what matters most is that internal tips always reach the intended party: *“Twice as an audit committee chair, I’ve had [information intended for me] sent and not had it reach me. In one case, we had a [senior executive] fired because of that information, although it didn’t reach me until a year later. So don’t assume those rules are in place.”*

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. Members say that determining whether or not the audit committee gets involved *“depends entirely on the nature of what happened.”* One member cautioned, *“If it is a small, low-level employee fraud, then management can usually handle it. There’s a tendency to overreact, and audit committees need to be careful.”*

When high-level fraud does occur, audit committee chairs should be ready for a significant time commitment: *“When we were involved in a senior management fraud investigation, we formed a small subcommittee of the audit committee that met every morning to discuss progress, so it became an almost daily reporting mechanism. We knew exactly where the investigation was headed at all times.”*

Some members agreed that it can be valuable for the board to retain independent outside counsel, either proactively or immediately upon a fraud allegation: *“When I was overseeing an allegation against a high-level employee, I wanted to have an accurate record of our investigation, so I worked with outside, independent counsel and the head of compliance throughout the whole thing.”* Another member said, *“We have standing counsel on retainer. It was the only way I would agree to be on the audit committee in the first place.”*

Members emphasized – and Messrs Kuzma and Taylor confirmed based on their experience – the particular value of keeping outside counsel and forensic accountants on retainer given the importance of speed in an investigation: *“If you have to launch an investigation and you don’t have counsel lined up in advance, you are going to have serious issues meeting your timetables.”*

Conclusion

Southeast Audit Committee Network members and their guests agree that directors need to be particularly mindful of fraud risks in the current economic environment. Recognizing that *“there is no silver bullet to all of this,”* members agree that having sound controls, talented and alert internal and external auditors, and good tone at the top are essential for mitigating a company’s exposure to acts of fraud and other corporate malfeasance. As one member remarked prior to the meeting, *“In times like these, people are sometimes tempted and led to do things they wouldn’t otherwise consider. So, it behooves us to step up our diligence, given the potential for [fraud] to occur.”*



Appendix: Questions for audit committees to consider

- ? How has the economic crisis affected your perception of fraud risk at your companies?
- ? 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?
- ? What steps is your committee taking to mitigate fraud risk? How do these differ from the actions you take in a healthy economic environment?
- ? How do you, as audit committee chair, contribute favorably to tone at the top?
- ? How has management adapted internal controls in the face of staffing reductions? What impact might this have on Section 404 compliance?
- ? 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?
- ? Under what circumstances should the audit committee participate in fraud investigations?
- ? What role should internal and external audit play in fraud prevention, detection, and investigation? How has this role changed in the last 12 months?

About this document

The Southeast Audit Committee Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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