

THE ANTI-FRAUD IMPERATIVE: Fraud Risk Management is No Longer Optional



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To quote 60's icon, Bob Dylan, "the times they are a-changin."

Many organizations, feeling the effects of globalization, plummeting credit markets, increased regulation and a host of other factors, have had to scrap established plans for growth and hunker down in survival mode.

When organizations are under duress, the pressure on management to perform provides an incentive not only for "right sizing" and cost controls but also for fraudulent activity. It should be, therefore, no surprise the number and size of corporate frauds are increasing – and that many investors are losing confidence in the credibility of financial statements.

Given the potential financial and non-financial consequences of fraudulent activities, fraud risk management is no longer an option but a business imperative. Leading companies recognize a sustainable competitive advantage is possible by embedding a systematic, integrated fraud risk management process.

AN EXAMINATION OF FRAUD

According to research conducted by the Association of Certified Fraud Examiners (ACFE) published in the 2008 *Report to the Nation on Occupational Fraud & Abuse*, U.S. businesses will lose an estimated seven percent of annual revenues to fraud. This translates into a staggering \$994 billion in fraud losses despite increased emphasis on

THREE CATEGORIES OF FRAUD

The ACFE breaks fraud into three main categories:

1. Financial Reporting Fraud

- Manipulation, falsification, alteration of accounting records
- Misrepresentation or intentional omission of amounts
- Misapplication of accounting principles
- Intentionally false, misleading or omitted disclosures

2. Misappropriation of Assets

- Theft of tangible assets by internal or external parties
- Theft/trading in intangible assets
- Sales of proprietary information
- Causing improper payments

3. Corruption

- Making or receiving improper payments
- Offering bribes to public or private officials
- Receiving bribes, kickbacks or other payments
- Aiding and abetting fraud by others

When broadly categorized as above, it is apparent fraud is a widespread problem that can affect almost every organization.

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anti-fraud controls and the passage of recent legislation to combat fraud.

To highlight the magnitude of these losses, let's assume an automobile manufacturer has:

- \$1 billion in annual revenue
- An average price per automobile of \$25,000
- A 20 percent margin - which translates into \$5,000 profit per car ($\$25,000 \times 0.20$)

Based on the ACFE's seven percent average loss attributable to fraudulent activity, this company could lose \$70 million of its revenue ($\$1 \text{ billion} \times 0.07$). At a 20 percent profit margin, this translates into \$14 million in lost profit. At a \$5,000 profit margin per car, the company would need to sell 2,800 cars simply to cover revenue leakage attributable to fraud ($2,800 \times \$5,000 = \14 million).

The quantitative logic above underscores the direct cost of fraudulent activity, and the example is applicable to any organization, regardless of size or type of business. In addition to direct costs, however, there are other and almost equally important indirect costs of fraud that can result in adverse consequences, including:

- Increased government intervention
- Loss of productivity
- Legal fees
- Loss of reputation and brand erosion
- Inability to secure funding

As long as there have been corporations, there have been corporate scandals. Too often, today's headline-making scandals are focused squarely on corporate fraud.

Case in point – the Bernie Madoff Ponzi scheme – which was described by prosecutors as “the largest investor fraud committed by a single person.” The Federal Bureau of Investigation's definition of a Ponzi scheme is an investment fraud where the operator promises high financial returns or dividends that are not available through traditional investments. Instead of investing victims' funds, the operator pays “dividends” to initial investors using the principle amounts invested by subsequent investors.

To perpetuate his ongoing swindle, Madoff successfully orchestrated various influencers as the foundation of his scheme. Key influencers included:

- A demonstrable track record for achieving success on Wall Street
- Significant personal knowledge of the workings of the regulatory agencies. Madoff had high-level family connections within the Securities Industry and Financial Markets

Association (SIFMA) and previously served as Chairman of the NASDAQ stock market

- Capitalizing on the social dynamic that if pedigree investors such as Hollywood and sporting celebrities, major hedge funds and prestigious non-profits are investing, it is a reasonable thing to do
- Establishing a sense of exclusivity to entice investors into his fraudulent scheme

Recently, Madoff was handed the maximum sentence of 150 years behind bars for crimes the judge described as an “extraordinary evil.” Numerous lessons can be learned from the Madoff scandal and leveraged as better practices to safeguard against similar fraudulent activity. Key lessons include:

- Use common sense at all times
- Perform appropriate diligence and exercise a degree of skepticism
- Pay attention to red-flags. In the case of Madoff, these would include expert warnings by market analysts, unusual business practices and the reputation of the external auditor

These same lessons can be applied to the case against the Stanford Financial Group. For years, Stanford Financial portrayed hypothetical investment results as actual historical data in sales pitches to clients. A February 11, 2009, Business Week article, *Is Stanford Financial's Offer Too Good to Be True?*, said “R. Allen Stanford sells supposedly super-safe certificates of deposit with interest rates more than twice the market average.” As unrealistic as that seems now, Stanford managed to entice clients to invest using those fictitious performance results. Shortly thereafter, the Securities and Exchange Commission charged Stanford with “massive ongoing fraud” centered on an eight billion dollar investment scheme.

Fraud and corporate scandals have no geographic boundaries. Consider the case of Satyam Computer Services, Ltd, a major Indian outsource provider that claimed to be the back office of more than 185 Fortune 500 companies. In an elaborate fraud scheme many consider “India's Enron,” Ramalinga Raju, company chairman, admitted material financial statement irregularity by vastly overstating revenues and bank balances – overstating revenues by 76 percent and profits by 97 percent. It is widely believed Raju's downfall is attributable to the chase of huge profits and pressure to meet investor expectations.

FRAUD OVERSIGHT

Governments and law enforcement everywhere are stepping up efforts to combat fraud, but its pervasive nature compounds the difficulty of stopping fraud before it occurs.

The U.S. Foreign Corrupt Practices Act (FCPA) was designed to halt bribery of foreign officials and restore public confidence in the integrity of the American business system. Enforcement of the FCPA is at an all-time high. The U.S. Department of

Justice (DOJ) and the Securities and Exchange Commission (SEC) brought twice as many cases in 2007 as in the previous year. This pace continued through 2008 with the number of enforcement actions only marginally below that of 2007.

In addition to expanding enforcement by the DOJ and SEC, penalties for noncompliance are escalating. The highest previous FCPA fine of \$44 million in 2007 was dwarfed by more recent penalties of \$1.6 billion and \$579 million levied against two multinational firms. These enormous penalties are expected to motivate additional FCPA prosecutions and increase the likelihood of even more future enforcement actions.

COMBATING FRAUD FROM WITHIN

Confronted with a near epidemic of fraud, what are organizations to do? While anti-fraud measures are the responsibility of every single employee, management is ultimately responsible for fraud risk management oversight. In addition to management, four key players have roles in the fight against fraud: internal audit, the Audit Committee, the Board of Directors and the external auditor.

Internal audit's primary responsibilities regarding fraud are in the areas of prevention and reporting. IIA Performance Standard 2121.A2 states, "The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages risk." Specifically as it relates to fraud, internal audit should:

- Provide assurance that fraud prevention and detection controls are sufficient for identified fraud risks
- Ensure the controls are functioning as designed
- Be alert for incidences of actual fraudulent activity
- In many instances, be responsible for initial or full investigation of suspected fraud schemes
- Assist in developing fraud awareness training for employers

The Audit Committee, on the other hand, has its own list of responsibilities related to fraud prevention, including:

- Having a thorough understanding of what constitutes fraud
- Evaluating management's identification of fraud risks
- Ensuring controls are in place to prevent, deter and detect fraud by management
- Assessing the risk of financial fraud by management
- Receiving whistleblower reports and following up on allegations
- Seeking the advice of counsel whenever there are allegations of fraud
- Analyzing patterns of fraud allegations to determine if there are underlying process issues

The role of the Board of Directors is to:

- Set the appropriate tone at the top as it relates to ethics, fraud and business practice

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CATEGORIES OF FCPA PROVISIONS AND BETTER PRACTICES

The Foreign Corrupt Practices Act consists of two primary sets of provisions:

- **Anti-bribery** - prohibits bribery of foreign government or political officials for the purpose of obtaining or retaining business or securing any improper business advantage
- **Accounting Standards and Internal Controls** - requires SEC-registered or reporting issuers to make and maintain accurate books and records and to implement adequate internal accounting controls

FCPA better practices include:

- Performing an inventory analysis of business partners, agents and other third parties
 - Are any of them state owned?
 - Are any employees government officials?
- Determining potential exposure to or contacts with foreign-government officials (including employees of state-owned businesses)
- Understanding the services to be provided and how the payments will be made
- Conducting a red-flag analysis and resolving as appropriate. Red flags include:
 - New customers being granted unusual credits
 - Inconsistent invoicing or over-invoicing
 - Requests that payments be made to a third party or in a third country
 - Foreign operations managers receiving unusual bonuses
 - Requests for extravagant gifts
 - Large commissions, retainers or fee requests
 - Unusually high service-related fees
 - Premiums added to contracts
 - Requests for cash

ELEMENTS OF AN EFFECTIVE FRAUD RISK MANAGEMENT PROGRAM

Better practice elements typically associated with a fraud risk management program include:

1. Fraud Risk Assessment

Perform a risk assessment of the nature, likelihood and impact of fraud

2. Policies and Standards

Define policies and standards that articulate acceptable business practices and anti-fraud standards

3. Training and Communication

Conduct anti-fraud training and provide related communication to elevate employee awareness of and to highlight their responsibilities

4. Investigation

Investigate allegations of fraud

5. Resolution

Take corrective action if appropriate

6. Evaluation and Reporting

Measure and report whether the program is operating as intended and make adjustments as needed



- Empower a committee of the Board (usually the Audit Committee) and external auditors to look for and report fraud
- Establish mechanisms to ensure the Board receives accurate and timely information

Lastly, the external auditors must:

- Assess management's processes
- Determine the entity's susceptibility to fraud

EFFECTIVE FRAUD RISK MANAGEMENT

Progressive companies recognize the strategic importance of imbedding a fraud risk management process throughout the organization. Effective fraud risk management provides an organization with the ability to manage fraud in a manner that satisfies both business and regulatory requirements, yielding the following benefits:

- Enhanced tangible and intangible asset protection
- Potential for profitability improvement
- Reinforcement of the company's reputation for high ethical standards
- Mitigated modern business realities that, on average, seven percent of revenue is at risk due to fraudulent activity
- Regulatory compliance with various federal and state statutes
- Improved ability to quantify losses to support insurable recovery claims

Furthermore, an embedded fraud risk management process reveals the damage fraud can do to the organization's business objectives. It is imperative, therefore, as part of the fraud management process, to accurately assess the risk of fraud occurring, develop solid responses to mitigate identified risks and seek to eliminate opportunities for fraud.

To be effective, a comprehensive fraud risk management process should comply with the Committee of Sponsoring Organizations of the Treadway Commission's Internal Control Framework, and incorporate fraud risk management/governance guidance of the Association of Certified Fraud Examiners, Institute of Internal Auditors, American Institute of Certified Public Accountants, and the New York Stock Exchange and NASDAQ.

Better practice also dictates that anti-fraud measures should be closely aligned with corporate values in such a way as to:

- Increase business integrity through strong corporate governance
- Decrease exposure to liability and litigation
- Encourage strong ethics and a culture of honesty

The times are changing. Fraud is on the rise. And establishing an effective fraud risk management process will take time, expertise and budget dollars. But any expenditures may be nothing when compared to the potential consequences of inaction— from loss of revenue to the very destruction of the organization.