McCombs Knowledge To Go

November 11, 2014
Corporate Governance and Corporate Fraud

by Grace Renbarger
Lecturer, Department of Business, Government and Society
Agenda

- What is Corporate Fraud?
- What are the Consequences?
- How Big is the Problem?
- Who Commits Corporate Fraud?
- Why do People Engage in Fraud?
- How can Fraud be Prevented?
- What is the Role of Corporate Governance in Preventing Corporate Fraud?
What is “Corporate Fraud”? 

"The alert status for corporate accounting fraud remains steady at orange."
What is “Corporate Fraud”?

- **Concept of “fraud” is very broad**
  - Legal Definition: A false representation of a matter of fact—whether by words or by conduct, by false or misleading statements, or by concealment of what should have been disclosed—that deceives and is intended to deceive another so that the individual will act upon it to his or her legal injury.

- **Type of “White Collar” crime**
- Usually committed for personal or institutional gain.
What is “Corporate Fraud”?

- Occurs in wide variety of ways:
  - theft of cash, physical assets or confidential information
  - misuse of accounts
  - procurement fraud
  - payroll fraud
  - financial accounting misstatements
  - inappropriate journal vouchers
  - suspense accounting fraud
  - fraudulent expense claims
  - false employment credentials
  - bribery and corruption
  - money laundering
- Can be committed by individuals employed by the corporation (internal) or by outsiders (external)
- Victims can be the corporation itself or others (e.g., investors)
What is “Corporate Fraud”? 
Focus today is on internal fraud

Source: Chartered Institute of Management Accountants
Figure 3: Occupational Fraud and Abuse Classification System (Fraud Tree)
Consequences of Fraud

- Criminal liability
  - Securities fraud
  - Insider trading
  - Tax evasion
  - Racketeering/RICO
  - Mail and wire fraud
  - Bribery
  - Money laundering
  - Obstruction of justice
Consequences of Fraud

- Individual officers, employees and agents criminally prosecuted for their own conduct
- Corporate officers, employees and agents can also be criminally prosecuted for the actions of others under these theories:
  - Conspiracy
  - Instruction, aiding and abetting, accessory after the fact
  - Responsible Corporate Officer Doctrine
Consequences

- **Criminal liability for corporation**
  - Acts, knowledge and intent of individuals will be imputed to corporation if individual was acting (a) within course, scope and authority of employment; and (b) at least partially for the benefit of the corporation

- **Criminal penalties include**
  - Monetary fines
  - Restitution
  - Forfeiture of property
  - Probation
  - License revocation, commission suspension, debarment
  - Prison (for individuals)

- **Civil liability**
  - Follow on litigation (class actions, shareholder derivative suits)

- **Reputation damage**
How Big is the Problem?

Figure 2: Distribution of Dollar Losses

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How Big is the Problem?

Figure 4: Occupational Frauds by Category — Frequency

<table>
<thead>
<tr>
<th>TYPE OF FRAUD</th>
<th>2014</th>
<th>2012</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Misappropriation</td>
<td>85.4%</td>
<td>86.7%</td>
<td>90.3%</td>
</tr>
<tr>
<td>Corruption</td>
<td>38.8%</td>
<td>32.6%</td>
<td>30.4%</td>
</tr>
<tr>
<td>Financial Statement Fraud</td>
<td>9.0%</td>
<td>7.6%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>

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How Big is the Problem?

Figure 5: Occupational Frauds by Category — Median Loss

- **Asset Misappropriation**
  - 2014: $130,000
  - 2012: $120,000
  - 2010: $135,000

- **Corruption**
  - 2014: $200,000
  - 2012: $250,000
  - 2010: $250,000

- **Financial Statement Fraud**
  - 2014: $1,000,000
  - 2012: $1,000,000
  - 2010: $4,100,000

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How Big is the Problem?

**Figure 19:** Size of Victim Organization — Frequency

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>2014</th>
<th>2012</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100</td>
<td>28.8%</td>
<td>31.8%</td>
<td>30.8%</td>
</tr>
<tr>
<td>100-999</td>
<td>23.6%</td>
<td>22.8%</td>
<td>27.5%</td>
</tr>
<tr>
<td>1,000-9,999</td>
<td>19.5%</td>
<td>18.8%</td>
<td>25.0%</td>
</tr>
<tr>
<td>10,000+</td>
<td>19.8%</td>
<td>20.8%</td>
<td>28.1%</td>
</tr>
</tbody>
</table>

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How Big is the Problem?

Figure 20: Size of Victim Organization — Median Loss

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How Big is the Problem?

Figure 17: Type of Victim Organization — Frequency

**Other** category was not included in the 2010 Report.
**How Big is the Problem?**

**Figure 18: Type of Victim Organization — Median Loss**

- **Private Company**: $160,000 (2014), $200,000 (2012), $231,000 (2010)
- **Public Company**: $127,000 (2014), $200,000 (2012), $200,000 (2010)
- **Government**: $300,000 (2014), $100,000 (2012), $100,000 (2010)
- **Not-for-Profit**: $100,000 (2014), $100,000 (2012), $60,000 (2010)
- **Other**: $75,000 (2014), $127,000 (2012)

**MEDIAN LOSS**

"Other" category was not included in the 2010 Report.

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How Big is the Problem?

Figure 22: Industry of Victim Organizations

- Banking and Financial Services: 17.8%
- Government and Public Administration: 10.3%
- Manufacturing: 8.5%
- Health Care: 7.9%
- Education: 5.9%
- Retail: 5.7%
- Insurance: 4.5%
- Other: 3.8%
- Oil and Gas: 3.0%
- Transportation and Warehousing: 3.5%
- Services (Other): 3.5%
- Construction: 3.1%
- Religious, Charitable or Social Services: 2.9%
- Technology: 2.9%
- Services (Professional): 2.3%
- Telecommunications: 2.6%
- Wholesale Trade: 2.2%
- Agriculture, Forestry, Fishing and Hunting: 2.1%
- Utilities: 1.8%
- Real Estate: 1.8%
- Arts, Entertainment and Recreation: 1.5%
- Communications and Publishing: 1.1%
- Mining: 1.0%
### How Big is the Problem?

**Figure 23: Industry of Victim Organizations (Sorted by Median Loss)**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Cases</th>
<th>Percent of Cases</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>13</td>
<td>1.0%</td>
<td>$900,000</td>
</tr>
<tr>
<td>Real Estate</td>
<td>24</td>
<td>1.8%</td>
<td>$555,000</td>
</tr>
<tr>
<td>Oil and Gas</td>
<td>49</td>
<td>3.6%</td>
<td>$450,000</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>31</td>
<td>2.3%</td>
<td>$375,000</td>
</tr>
<tr>
<td>Technology</td>
<td>39</td>
<td>2.9%</td>
<td>$250,000</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>116</td>
<td>8.5%</td>
<td>$250,000</td>
</tr>
<tr>
<td>Construction</td>
<td>43</td>
<td>3.1%</td>
<td>$245,000</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishing and Hunting</td>
<td>28</td>
<td>2.0%</td>
<td>$242,000</td>
</tr>
<tr>
<td>Transportation and Warehousing</td>
<td>48</td>
<td>3.5%</td>
<td>$202,000</td>
</tr>
<tr>
<td>Banking and Financial Services</td>
<td>244</td>
<td>17.8%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Services (Professional)</td>
<td>37</td>
<td>2.7%</td>
<td>$180,000</td>
</tr>
<tr>
<td>Health Care</td>
<td>100</td>
<td>7.3%</td>
<td>$175,000</td>
</tr>
<tr>
<td>Arts, Entertainment and Recreation</td>
<td>22</td>
<td>1.6%</td>
<td>$168,000</td>
</tr>
<tr>
<td>Other</td>
<td>52</td>
<td>3.6%</td>
<td>$130,000</td>
</tr>
<tr>
<td>Services (Other)</td>
<td>45</td>
<td>3.3%</td>
<td>$125,000</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>36</td>
<td>2.6%</td>
<td>$120,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>25</td>
<td>1.8%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>62</td>
<td>4.5%</td>
<td>$93,000</td>
</tr>
<tr>
<td>Religious, Charitable or Social Services</td>
<td>40</td>
<td>2.9%</td>
<td>$80,000</td>
</tr>
<tr>
<td>Government and Public Administration</td>
<td>141</td>
<td>10.3%</td>
<td>$64,000</td>
</tr>
<tr>
<td>Education</td>
<td>80</td>
<td>5.9%</td>
<td>$58,000</td>
</tr>
<tr>
<td>Retail</td>
<td>77</td>
<td>5.6%</td>
<td>$54,000</td>
</tr>
<tr>
<td>Communications and Publishing</td>
<td>15</td>
<td>1.1%</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
### How Big is the Problem?

**Figure 25: Corruption Cases by Industry**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Total Number of Cases</th>
<th>Number of Corruption Cases</th>
<th>Percent of Cases Involving Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>13</td>
<td>9</td>
<td>69.2%</td>
</tr>
<tr>
<td>Oil and Gas</td>
<td>49</td>
<td>28</td>
<td>57.1%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>116</td>
<td>63</td>
<td>54.3%</td>
</tr>
<tr>
<td>Construction</td>
<td>43</td>
<td>20</td>
<td>46.5%</td>
</tr>
<tr>
<td>Other</td>
<td>52</td>
<td>24</td>
<td>46.2%</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>36</td>
<td>15</td>
<td>41.7%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>24</td>
<td>10</td>
<td>41.7%</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>31</td>
<td>12</td>
<td>39.7%</td>
</tr>
<tr>
<td>Banking and Financial Services</td>
<td>244</td>
<td>91</td>
<td>37.3%</td>
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<td>37</td>
<td>37.0%</td>
</tr>
<tr>
<td>Education</td>
<td>80</td>
<td>29</td>
<td>36.3%</td>
</tr>
<tr>
<td>Government and Public Administration</td>
<td>141</td>
<td>51</td>
<td>36.2%</td>
</tr>
<tr>
<td>Utilities</td>
<td>25</td>
<td>9</td>
<td>36.0%</td>
</tr>
<tr>
<td>Services (Other)</td>
<td>45</td>
<td>16</td>
<td>35.6%</td>
</tr>
<tr>
<td>Insurance</td>
<td>62</td>
<td>21</td>
<td>33.9%</td>
</tr>
<tr>
<td>Communications and Publishing</td>
<td>15</td>
<td>5</td>
<td>33.3%</td>
</tr>
<tr>
<td>Technology</td>
<td>39</td>
<td>13</td>
<td>33.3%</td>
</tr>
<tr>
<td>Religious, Charitable or Social Services</td>
<td>40</td>
<td>12</td>
<td>30.0%</td>
</tr>
<tr>
<td>Services (Professional)</td>
<td>37</td>
<td>11</td>
<td>29.7%</td>
</tr>
<tr>
<td>Transportation and Warehousing</td>
<td>48</td>
<td>14</td>
<td>29.2%</td>
</tr>
<tr>
<td>Arts, Entertainment and Recreation</td>
<td>22</td>
<td>6</td>
<td>27.3%</td>
</tr>
<tr>
<td>Retail</td>
<td>77</td>
<td>17</td>
<td>22.1%</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishing and Hunting</td>
<td>28</td>
<td>5</td>
<td>17.9%</td>
</tr>
</tbody>
</table>

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How Big is the Problem?

- Fines and Penalties

*Total corporate criminal penalties 2001-2012*

$5 billion

Sources: U.S. Department of Justice; Brandon Garrett, “Too Big to Jail,” Harvard University Press

S. Culp, 05/06/2014
How Big is the Problem?

- Sampling of largest corporate criminal fines, penalties and settlements with government regulators over past 10 years (excluding cases related to the financial crisis):
  - $8.97B – BNP Paribas for violating US trade sanctions against Sudan, Iran and others (2014)
  - $3B – Glaxo-Smith-Kline for illegally marketing drugs (including paying kickbacks to doctors) (2012)
  - $2.6B – JP Morgan Chase for insufficient controls that enabled Bernie Madoff to launder proceeds from Ponzi scheme (2014)
  - $2.6B – Credit Suisse for conspiracy to aid tax evasion (2014)
  - $2.4B – Time Warner for securities fraud relating to failed merger with AOL (2005)
  - $2.3B – Pfizer for misleading consumers about pain drug (2009)
How Big is the Problem?

- $1.9B – HSBC Holdings for deficiencies in anti-money laundering controls (2013)
- $1.6B – Seimens, A.G. for bribing foreign officials (2008)
- $1.6B – A.I.G. for illegal kickbacks, financial reporting fraud and tax evasion (2006)
- $1.5B – UBS, A.G. for manipulating interbank lending rates including London interbank offered rate (Libor)
- $1.5B – Enron for financial and securities fraud (2005)
- $1.5B – Abbot Labs for illegally promoting anti-seizure drug (2012)
- $1.45B – Intel for violating European anti-competition laws (2009)
- $1.42B – Eli Lilly Co. for improper marketing of anti-psychotic drug (2009)
- $1B – JP Morgan Chase for securities fraud involving losses by trader known as London Whale (2013)
Welcome to the Office of the Whistleblower

Assistance and information from a whistleblower who knows of possible securities law violations can be among the most powerful weapons in the law enforcement arsenal of the Securities and Exchange Commission. Through their knowledge of the circumstances and individuals involved, whistleblowers can help the Commission identify possible fraud and other violations much earlier than might otherwise have been possible. That allows the Commission to minimize the harm to investors, better preserve the integrity of the United States' capital markets, and more swiftly hold accountable those responsible for unlawful conduct.

The Commission is authorized by Congress to provide monetary awards to eligible individuals who come forward with high-quality original information that leads to a Commission enforcement action in which over $1,000,000 in sanctions is ordered. The range for awards is between 10% and 30% of the money collected.
Who Commits Corporate Fraud?

- **Typical “Fraudster”**
  - Male
  - 36 to 45 years old
  - Commits fraud against own employer
  - Works in finance function or finance-related role
  - Holds senior management position
  - Employed by company for more than 10 years
  - Works in collusion with another perpetrator

Source: KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*
### Who Commits Corporate Fraud?

**Source:** KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*

<table>
<thead>
<tr>
<th>Age of Fraudster</th>
<th>2007 Survey</th>
<th>2011 Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>18 to 25 years old</td>
<td>3%</td>
<td>2%</td>
</tr>
<tr>
<td>26 to 35 years old</td>
<td>14%</td>
<td>12%</td>
</tr>
<tr>
<td>36 to 45 years old</td>
<td>39%</td>
<td>41%</td>
</tr>
<tr>
<td>46 to 55 years old</td>
<td>31%</td>
<td>35%</td>
</tr>
<tr>
<td>Older than 55 years</td>
<td>13%</td>
<td>10%</td>
</tr>
</tbody>
</table>
Who Commits Corporate Fraud?

Rank within the organization

- **Staff**
  - 2007: 14%
  - 2011: 18%

- **Management**
  - 2007: 26%
  - 2011: 29%

- **Senior Management**
  - 2007: 60%
  - 2011: 53%

Source: KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*
### Who Commits Corporate Fraud?

**Where the fraudster works**

<table>
<thead>
<tr>
<th>Department</th>
<th>2007 Survey</th>
<th>2011 Survey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research &amp; Development</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>Procurement</td>
<td>9%</td>
<td>8%</td>
</tr>
<tr>
<td>Operations/Sales</td>
<td></td>
<td>25%</td>
</tr>
<tr>
<td>Legal</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>Finance</td>
<td></td>
<td>32%</td>
</tr>
<tr>
<td>CEO</td>
<td>11%</td>
<td>26%</td>
</tr>
<tr>
<td>Board level</td>
<td>2%</td>
<td>7%</td>
</tr>
<tr>
<td>Back office</td>
<td>5%</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*
Who Commits Corporate Fraud?

Time at the organization

- Less than 1 year: 4% (2007), 1% (2011)
- 1 to 2 years: 9% (2007), 10% (2011)
- 3 to 5 years: 29% (2007), 27% (2011)
- 6 to 10 years: 29% (2007), 27% (2011)
- More than 10 years: 33% (2011)

Source: KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*
Who Commits Corporate Fraud?

Lone fraudster, or colluding with others?

Source: KPMG 2011 Global Fraud Study, *Who is the typical fraudster?*
Why do People Commit Fraud?

- Traditional view:

  First articulated by sociologist and criminologist Donald Cressey in his 1953 book *Other People’s Money*
Why do People Commit Fraud?

- **Propensity and Frugality Theory**
  - CEOs and CFOs who have record of legal infractions are more likely to be named in connection with fraudulent corporate reporting in an SEC Accounting and Auditing Enforcement Release (AAER). (“Propensity”)

Why do People Commit Fraud?

- **Propensity and Frugality**
  - Fraudulent and erroneous financial reporting by other insiders are higher in firms run by a CEO who owns significant luxury goods ("Non-frugality")

Why do People Commit Fraud?

**Behavioral Ethics Theory***

- Grounded in social psychology, neuropsychology, evolutionary biology, behavioral economics
- One researcher estimates that 3-4% of those in senior positions in business are psychopaths (as compared to 1% in the US general population)
- But most fraud perpetrated by people who consider themselves to have good moral character
- Ethical lapses can be explained by psychological concepts
- Situational factors (pressure) outweigh internal disposition (character)
- Consistent with traditional fraud triangle

Why do People Commit Fraud?

- **Heuristics & Cognitive Biases**
  - Mental shortcuts used to ease the cognitive load of making a decision
  - Usually very adaptive but can lead to unethical decisions if they overwhelm our ability to see the big picture (moral myopia)
Why do People Commit Fraud?

- Heuristics & Cognitive Biases
  - Acceptability heuristic

Obedience to authority

Conformity bias
Why do People Commit Fraud?

Heuristics & Cognitive Biases

- Self serving bias

- Conformity bias

Confirmation Bias Inc.
Why do People Commit Fraud?

- Heuristics & Cognitive Biases

Over confidence/Superiority/Exceptionalism
Why do People Commit Fraud?

- **Heuristics & Cognitive Biases**

**Sunk costs/Escalating Commitment**

- Money Already Spent
- Pride Issues
- Being Unsure
- Stuck with the wrong decision
- Finish What You Began
- Self-interest
- Losing Face

**Loss aversion/Endowment effect**

[Graph showing loss aversion and endowment effect]
Why do People Commit Fraud?

- **Heuristics & Cognitive Biases**

  **Tangible v. abstract**

  ![Stock Exchange](image1)

  **Short term v. long term**

  ![Quarterly Earnings](image2)

  ![Tree with Money Sign](image3)
Why do People Commit Fraud?

- Cognitive Dissonance & Moral Disengagement
- Rationalizations
  - Denial of Responsibility
  - Denial of Injury
  - Denial of Victim
  - Social weighting
  - Appeal to higher loyalties
  - Metaphor of the ledger
    - Moral compensation
    - Ethical licensing
Why do People Commit Fraud?

- Socialization of Corruption
  - Co-optation
  - Compromise
  - Incrementalism
Why do People Commit Fraud?

“I’m neither a good cop nor a bad cop, Jerome. Like yourself, I’m a complex amalgam of positive and negative personality traits that emerge or not, depending on circumstances.”
Shameless Plug

A series of award-winning short videos that explain behavioral ethics concepts, written and narrated by McCombs’ Business Government & Society Department Chair, Robert Prentice. [http://ethicsunwrapped.utexas.edu/](http://ethicsunwrapped.utexas.edu/)
How can Fraud Be Prevented?

- Since fraud is a human behavior, it can’t be eliminated completely
- But there are things corporations can do to reduce the likelihood that it will occur
  - Create ethical culture (to counter “pressure” and reduce “rationalization”)
  - Adopt effective internal controls (to reduce “opportunity”)

![The Fraud Triangle Diagram]

- **Rationalization**: Justification of dishonest actions.
- **Opportunity**: Ability to carry out misappropriation of cash or organizational assets.
- **Pressure**: Motivation or incentive to commit fraud.
How can Fraud Be Prevented?

A sampling of compliance and fraud prevention requirements and frameworks

- Federal Sentencing Guidelines for Organizations
- COSO’s Internal Controls—Integrated Framework
- Sarbanes-Oxley/Dodd-Frank laws
- NYSE corporate governance guidelines
- SEC’s Seaboard report
- Credit rating agencies
- D&O insurability standards
- Council of Institutional Investors
- Institute of Internal Auditors
- Association of Certified Fraud Examiners
- American Institute of CPAs
- Accounting Firms
- PCOB
How can Fraud Be Prevented?

- Elements of effective ethics and compliance program designed to prevent, detect and deter misconduct (including fraud)
  - Oversight and governance
    - Personnel with adequate resources and access
    - Senior management and Board involvement
    - Regular reporting on activities and effectiveness
  - Scope: program applicable to
    - Directors, officers, managers, employees, agents, suppliers, successors
  - Risk assessment
    - Activities
    - Locations
    - Third parties
  - Adopt standards, policies and procedures
    - Code of Conduct
    - Policies
    - Internal controls
How can Fraud Be Prevented?

- Culture, Communication and Training
  - Tone at the top
  - Targeted role- and risk-based training
  - Incentives and due diligence

- Detection Mechanisms
  - Whistleblower options (multiple)
  - Audits
  - Red flags and warning signs

- Responsive action
  - Escalation path
  - Investigation
  - Remediation and discipline
  - Communication: internal and external (self-report; disclosure)

- Monitoring and Evaluation
  - Metrics to assess effectiveness
  - Trend analysis
  - Surveys
  - Controls testing
  - Continuous feedback
How can Fraud Be Prevented?

Scope

- Risk Assessment
- Standards & Policies
- Culture & Training
- Detection
- Evaluation & Feedback
- Investigation & Remediation
- Governance & Oversight

Standards & Policies

Risk Assessment

Evaluation & Feedback

Investigation & Remediation

Detection

Governance & Oversight

Culture & Training
How can Fraud Be Prevented?

- **Types of internal controls (high level)**
  - Preventive
    - Authorization and approval procedures
    - Supervision (assigning, reviewing/approving guidance, training)
    - Segregation of duties (authorizing, processing, recording, reviewing)
    - Controls over access to resources and records
  - Detective
    - Reviews of operating performances
    - Reconciliations
    - Verifications
    - Reviews of processes and activities
  - Corrective
    - Submit corrective journal entries after discovering error;
    - Complete changes to IT access lists if individual’s role changes
How Can Fraud be Prevented?

Figure 26: Frequency of Anti-Fraud Controls

- External Audit of F/S: 81.4%
- Code of Conduct: 77.4%
- Internal Audit Department: 70.8%
- Management Certification of F/S: 70.8%
- External Audit of ICOFR: 85.2%
- Management Review: 82.0%
- Independent Audit Committee: 82.0%
- Hotline: 54.1%
- Employee Support Programs: 52.4%
- Fraud Training for Managers/Executives: 47.8%
- Fraud Training for Employees: 47.8%
- Anti-Fraud Policy: 45.4%
- Dedicated Fraud Department, Function or Team: 30.6%
- Proactive Data Monitoring/Analysis: 34.0%
- Formal Fraud Risk Assessments: 32.5%
- Surprise Audits: 33.2%
- Job Rotation/Mandatory Vacation: 19.9%
- Rewards for Whistleblowers: 10.5%
## How Can Fraud be Prevented?

### Figure 37: Median Loss Based on Presence of Anti-Fraud Controls

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent of Cases</th>
<th>Control in Place</th>
<th>Control Not in Place</th>
<th>Percent Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proactive Data Monitoring/Analysis</td>
<td>34.8%</td>
<td>$73,000</td>
<td>$181,000</td>
<td>59.7%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>52.4%</td>
<td>$90,000</td>
<td>$200,000</td>
<td>55.0%</td>
</tr>
<tr>
<td>Management Review</td>
<td>62.6%</td>
<td>$100,000</td>
<td>$208,000</td>
<td>51.9%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>77.4%</td>
<td>$100,000</td>
<td>$200,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>Internal Audit Department</td>
<td>70.6%</td>
<td>$100,000</td>
<td>$180,000</td>
<td>44.4%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>33.5%</td>
<td>$94,000</td>
<td>$168,000</td>
<td>44.0%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>33.2%</td>
<td>$93,000</td>
<td>$164,000</td>
<td>43.3%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>65.2%</td>
<td>$103,000</td>
<td>$180,000</td>
<td>42.8%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>47.8%</td>
<td>$100,000</td>
<td>$168,000</td>
<td>40.5%</td>
</tr>
<tr>
<td>Hotline</td>
<td>54.1%</td>
<td>$100,000</td>
<td>$168,000</td>
<td>40.5%</td>
</tr>
<tr>
<td>Dedicated Fraud Department, Function or Team</td>
<td>38.6%</td>
<td>$100,000</td>
<td>$164,000</td>
<td>39.0%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>47.8%</td>
<td>$100,000</td>
<td>$164,000</td>
<td>39.0%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>45.4%</td>
<td>$100,000</td>
<td>$155,000</td>
<td>35.5%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>70.0%</td>
<td>$120,000</td>
<td>$184,000</td>
<td>34.8%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>19.9%</td>
<td>$100,000</td>
<td>$150,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>81.4%</td>
<td>$125,000</td>
<td>$186,000</td>
<td>32.8%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>10.5%</td>
<td>$100,000</td>
<td>$135,000</td>
<td>25.9%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>62.0%</td>
<td>$120,000</td>
<td>$150,000</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

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## How Can Fraud be Prevented?

### Figure 38: Median Duration of Fraud Based on Presence of Anti-Fraud Controls

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent of Cases</th>
<th>Control in Place</th>
<th>Control Not in Place</th>
<th>Percent Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surprise Audits</td>
<td>33.2%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Proactive Data Monitoring/Analysis</td>
<td>34.8%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Dedicated Fraud Department, Function or Team</td>
<td>38.6%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>45.4%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>47.6%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Hotline</td>
<td>54.1%</td>
<td>12 months</td>
<td>24 months</td>
<td>50.0%</td>
</tr>
<tr>
<td>Formal Fraud Risk Assessments</td>
<td>33.5%</td>
<td>12 months</td>
<td>23 months</td>
<td>47.8%</td>
</tr>
<tr>
<td>Management Review</td>
<td>62.6%</td>
<td>13 months</td>
<td>24 months</td>
<td>45.8%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>62.0%</td>
<td>14 months</td>
<td>24 months</td>
<td>41.7%</td>
</tr>
<tr>
<td>Internal Audit Department</td>
<td>70.6%</td>
<td>14 months</td>
<td>24 months</td>
<td>41.7%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>19.9%</td>
<td>12 months</td>
<td>20 months</td>
<td>40.0%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>47.8%</td>
<td>13 months</td>
<td>21 months</td>
<td>38.1%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>65.2%</td>
<td>15 months</td>
<td>24 months</td>
<td>37.5%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>70.0%</td>
<td>15 months</td>
<td>24 months</td>
<td>37.5%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>10.5%</td>
<td>12 months</td>
<td>18 months</td>
<td>33.3%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>77.4%</td>
<td>16 months</td>
<td>24 months</td>
<td>33.3%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>81.4%</td>
<td>18 months</td>
<td>24 months</td>
<td>25.0%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>52.4%</td>
<td>14 months</td>
<td>18 months</td>
<td>22.2%</td>
</tr>
</tbody>
</table>
How Can Fraud be Prevented?

Figure 39: Primary Internal Control Weakness Observed by CFE

*Lack of Internal Controls* 32.2%
*Lack of Management Review* 18.2%
*Override of Existing Internal Controls* 11.6%
*Poor Tone at the Top* 10.4%
*Lack of Competent Personnel in Oversight Roles* 9.4%
*Other* 4.0%
*Lack of Independent Checks/Audits* 8.6%
*Lack of Employee Fraud Education* 6.4%
*Lack of Clear Lines of Authority* 2.9%
*Lack of Reporting Mechanism* 1.3%

PERCENT OF CASES

*"Other" category was not included in the 2010 Report.*
Role of Corporate Governance?

- Corporate governance is the “system by which companies are directed and controlled.” – Sir Adrian Cadbury, *The Committee on the Financial Aspects of Corporate Governance*, 1992).

- Corporate governance is the *relationship* among various participants in determining the direction and performance of corporations. The primary participants are: shareholders; company management (led by the chief executive officer); and the board of directors. – CalPERS

- Corporate governance is about “the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated.” – Margaret Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, 1995.
Role of Corporate Governance?

Corporate Governance

ERM/COSO

Internal Controls

Compliance

Fraud-specific measures
Role of Corporate Governance?

- **Board of Director’s role in fraud prevention**
  - Boards are charged with directing the management of the business and affairs of the corporation and have fiduciary duties of care and loyalty to shareholders. (e.g., 8 Del. C. Sec. 141(a))
  - Directors face personal liability for breach of fiduciary duty for either knowingly causing the corporation to violate the law or for failing to establish an effective system for monitoring the corporation's compliance with the law.*
  - SOX 301 requires Audit Committees to establish procedures for handling complaints regarding accounting, internal controls and auditing matters, and for the confidential submission by employees of concerns regarding questionable accounting or auditing matters.
  - U.S. Federal Sentencing Guidelines and other frameworks and standards require Boards to provide oversight of company’s risk management and compliance activities including accounting and financial reporting.

*In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).*
Role of Corporate Governance?

- **Board of Director’s role in fraud prevention**
  - DHB Industries – CEO convicted of defrauding company of more than $185 million
  - Shortly thereafter, SEC brought civil charges against 3 of DHB’s outside directors accusing them of willfully and repeatedly “turning a blind eye to numerous, significant, and compounding” warning signs of a massive financial statement fraud and asset misappropriation scheme by executive management
  - SEC asserted that the fraud “was facilitated by the egregious, wholesale failure of the company’s board to act in the face of mounting red flags”
  - The Directors paid $1.6 million to settle the charges and were permanently barred from serving as officers or directors of public companies

Role of Corporate Governance?

- Advice to Directors from SEC Chair Mary Jo White*
  - Embrace your role as “gatekeeper” in helping prevent, detect and stop unlawful activity
  - Establish tone at the very top
    - Set expectations for senior management and company as a whole regarding ethics and compliance – insist on establishment of enterprise-wide and adequately-resourced ethics and compliance program that applies to everyone (even top performers)
    - Exercise due diligence in hiring and evaluating CEO and other members of senior management to make sure they “get it”
    - Make it obvious that the Board and senior management highly value and respect the company’s legal and compliance functions
  - Be engaged: understand the business and its risks, its financial conditions, the industry, competitors
    - Require timely and thorough information from management; listen to what they say and what they don’t say
    - Ask the difficult questions; don’t ignore red flags
  - Listen to what regulators and shareholders are saying

*Address to Stanford University Director’s College, June 23, 2014
Contact info:
Grace Fisher Renbarger, J.D.
grace.renbarger@mccombs.utexas.edu
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