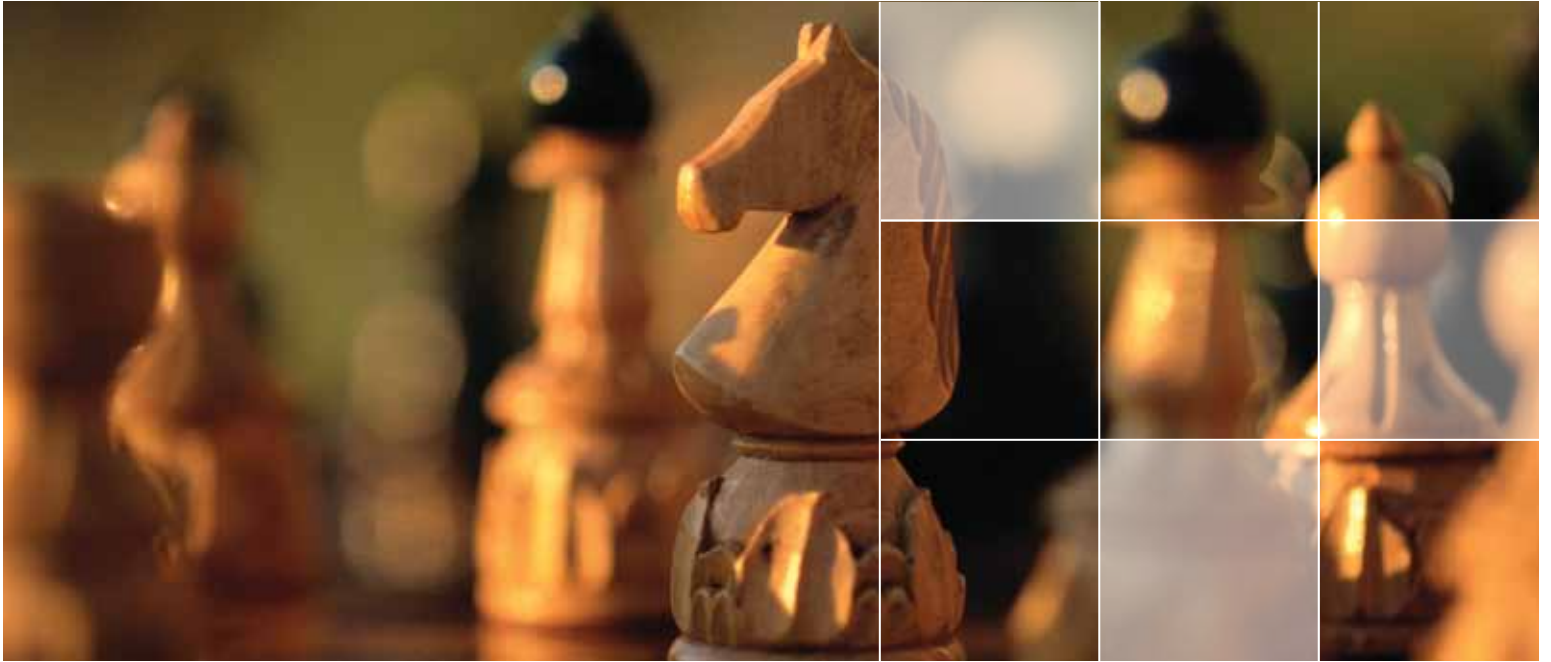


# Playing Offense in a High-risk Environment



The Unique Alternative to the Big Four®

“Today’s fraudster is clever and operates in an environment ripe for criminal activity. Economic unrest is making it easier for employees to find ways to set fraud in motion – and a new breed of offenders is finding cunning ways to do so. After more than 60 years, the classic fraud triangle of three elements or events that motivate an employee to cross the line has morphed into a Crowe Fraud Pentagon.<sup>™</sup> Company boards and senior management must take an offensive stance against the five conditions that precipitate fraud with a clear plan that limits the opportunity for fraud and minimizes the impact when fraud does occur.”

Jonathan Marks, CPA, CFE, CFF, Executive  
Crowe Horwath LLP



## Issues

With the economic downturn forcing budget cuts, reorganizations, and work force reductions, the pressure on corporations and key individuals to meet performance targets is elevated. So too is the risk of fraud. Each corporate change presents yet another opportunity for individuals to slip in undetected and override controls in their quest to meet performance targets, pad their pockets, or prime the machine for corporate advancement.

The cost of fraud can be astronomical. Twenty years ago, when ZZZZ Best Co. Inc., founder Barry Minkow lied, stole, and cheated his way to higher stock prices, the cost to investors was about \$26 million. Today, potential losses from New York money manager Bernard Madoff's alleged Ponzi scheme could be \$50 billion or more. In both cases, economic pressure and greed played key roles in the deception.

Most business executives have had to deal with incidents of fraud, the largest of which can result in management shake-ups, corporate closures, and the erosion of confidence in capital markets. All criminal activity can tarnish the reputation and brands of affected organizations, and it is increasingly resulting in hefty fines or settlement fees. In January 2009, Halliburton Energy Services agreed to pay \$559 million to settle federal charges that a former unit bribed Nigerian officials.<sup>1</sup> Pfizer Inc. similarly agreed to pay \$2.3 billion to settle a federal probe into the marketing of the painkiller Bextra.<sup>2</sup>

### The Five Elements of the Crowe Fraud Pentagon

Knowing what might provoke an employee, even an otherwise lawful individual, to blur the line between legal and illegal activity is the key to fighting fraud effectively. Famed criminologist Donald R. Cressey first identified three elements – opportunity (including general knowledge and technical skill), pressure, and rationalization – as the “fraud triangle” in the 1950s to explain why people commit fraud.<sup>3</sup> Cressey’s classic fraud triangle helps to explain many but not all situations.

Fraud is more likely to occur when someone has an incentive (pressure) to commit fraud, weak controls provide the opportunity for a person to do so, and the person is able to rationalize the fraudulent behavior.

Today’s fraudster is more independent-minded and armed with more information and access to corporate assets than was the perpetrator of Cressey’s era. Corporations have evolved to rely more heavily on outsourcing, global partnerships, and the technology that links them together. The corporate ladder structure common in the 1950s has given way to matrix organizations where individuals with greater autonomy have the authority to effect change across the organization. Performance-based pay and rewards, commonly replacing step-up pay structures, create greater incentive for employees to find unethical ways to reach performance targets.

Corporate culture today celebrates wealth and fame, creating a push among employees for hefty payouts and greater recognition at any price. And since many businesses no longer are owner-managed, managers and directors at the helm are unlikely to bear ownership costs when mishaps occur.

Then and Now	
1950s	2000s
Straight-line reporting authority	Matrix organizations
Dual responsibility	Autonomous authority
Single suppliers	Multiple vendors and global trading partners
Local or regional service area	Global reach
Step-up salary structure	Performance-based pay
CEO as businessman	CEO as celebrity
Businesses led by owners	Businesses led by managers and directors

These differences support the need to expand the fraud triangle to a five-sided Crowe's Fraud Pentagon, where an employee's competence or power to perform and arrogance or lack of conscience are factored into the conditions generally present when fraud occurs. Competence expands on Cressey's element of opportunity to include an individual's ability to override internal controls and to socially control the situation to his or her advantage. Arrogance or lack of conscience is an attitude of superiority and entitlement or greed on the part of a person who believes that corporate policies and procedures simply do not personally apply. This person, perhaps fueled by today's obscene compensation structures, has complete disregard for the consequences bestowed upon his or her victims. Competence and arrogance play a major role in determining whether an employee today has what it takes to perpetrate a fraud.

Unchecked, the five elements – pressure, opportunity, rationalization, competence, and arrogance – can provoke an individual to commit fraud. Adept individuals with widespread access to corporate information, a mindset of entitlement, and the confidence to pull it off compound the risk of fraud. Moreover, placing these individuals in a culturally lax environment with a poor tone at the top and weak internal controls is a recipe for disaster. A company with such conditions could become the lead scandal in tomorrow's news.

Each of these five drivers of fraud is present to some extent in companies at all times, but never more so than in the current pressure-filled corporate environment.



### **Antifraud Management**

The goal of today's corporate antifraud programs is to limit fraud by minimizing the opportunity or temptation people might have to override controls for personal gain. An employee might be able to rationalize why overselling inventory to boost end-of-month sales figures makes sense, but if there is no opportunity to co-opt corporate sales figures, fraud is unlikely to occur.

Recent corporate scandals have led the public, stakeholders, and, increasingly, regulators to expect organizations to have an antifraud management program in place. An effective, sustainable program puts in place controls that not only limit opportunity but also counter the four emotional drivers of fraud – pressure, rationalization, competence, and arrogance.

Senior management can begin to build an antifraud program by determining the company's fraud risk baseline with a thorough environmental assessment. With an understanding of this fraud risk baseline, internal and cultural controls are layered onto the baseline to prevent and detect fraud. A rapid management response plan is added last to complete a program that monitors suspicious activities as well as changes in the emotive fraud posture of the organization.

## **Trends**

### **Risky Environment**

Corporate fraud is on the rise, and despite laws and federal actions to curb abuse, the trend is expected to continue. The 2008 Kroll Global Fraud Report found that more than 85 percent of surveyed companies had suffered from corporate fraud in the previous three years. The number of executives that consider their companies vulnerable to some type of fraud increased 5 percent last year. Surveyed executives cited the greatest potential threats as physical theft, information loss or attack, compliance breaches, management conflict of interest, financial mismanagement, and procurement fraud.<sup>4</sup>

The cost of fraud is climbing as well. In its "2008 Report to the Nation on Occupational Fraud and Abuse," the Association of Certified Fraud Examiners reported that U.S. organizations lost an estimated 7 percent (up from 5 percent in 2006), or \$994 billion, of annual revenue to fraud in 2007.<sup>5</sup>

In the current global financial crisis, depressed earnings across industries, markets, and borders heighten the overall risk of fraud. Employees are under pressure to meet performance targets and find new ways to boost earnings, often relying on higher-risk opportunities or creative accounting maneuvers to capture elusive profits.

The opportunity for fraud is greatest at companies that are restructuring through downsizing, mergers, acquisitions, and sales. In the upheaval, as people change roles and new reports are assigned, internal controls previously put in place might be applied inconsistently, or not at all, thus creating more opportunity for fraud to occur.

In a tumultuous environment, employees often can find more ways to rationalize fraud. If an employee's bonus is based on an increase in net income but corporate earnings are down, the employee is more likely to think cutting corners or committing a crime is justified.

### Intensified Scrutiny

The recent rash of alleged and actual corporate misdeeds at public companies has stakeholders more actively scrutinizing performance reports and management efforts to ensure ethical behavior. The public and investors are more aware of companies that are required to restate financial reports. Struggling companies, like U.S. automakers, are under greater scrutiny as stakeholders consider whether to continue to back or bail out on poor performers.

Federal regulators and agencies, including the Federal Bureau of Investigation (FBI), are directing more resources to rooting out accounting fraud, insider trading, and deceptive sales practices at investment banks, mortgage companies, private equity firms, and hedge funds. In 2007 alone, FBI efforts secured more than 490 corporate and securities fraud convictions, including 33 insider-trading indictments against employees at Goldman Sachs, Morgan Stanley, Credit Suisse, and UBS Securities.<sup>6</sup>

Emerging standards are further raising awareness of effective antifraud measures. Top accounting organizations came together recently to issue fraud guidance titled “Managing the Business Risk of Fraud: A Practical Guide.” The guidelines represent the first set of industry-generated standards for antifraud programs. Over time, these guidelines might prove to be the basis of case law that defines how regulators and enforcement agencies oversee fraud management efforts and prosecute fraud.<sup>7</sup>

## Gaps

The idea that fraud cannot happen in an ethical company is false. So too is the idea that preventive measures are enough to stop fraud. When top management holds these assumptions, internal controls are often lax, creating a breeding ground for fraudulent activity.

Fraud can happen anywhere. In fact, companies that best address corporate crime are typically those that have been stung by instances of stock option backdating, asset theft, or insider trading. Although the cost to fight actual fraud is staggering, far too many executives still refuse to promote effective preventive measures.

Preventive measures, though, are not enough. It is not practical to put checks and balances on every transaction, every employee, and every corporate relationship in an organization. That is why it is critical that the tone of top management be strong on crime prevention, detection, and prosecution.<sup>8</sup>

The best antifraud programs assess where fraud is most likely to occur within an organization and why. Companies that skip the fraud assessment are risking putting controls in the wrong place. Or they might overburden one area, such as expense reporting, with multiple layers of review while ignoring other areas, such as procurement or invoicing processes. A fraud assessment provides the basis for a risk-based approach to designing controls that fit the organization.

## Challenges

Fraud can assume many forms in an organization. A member of the board of directors could have undisclosed conflicts of interest, rank-and-file employees might be misappropriating assets, and customers could be pocketing kickbacks. Although various technological solutions create internal controls to minimize the opportunity for wrongdoing, fraud that occurs outside the technology environment – such as price collusion with competitors and theft of product designs – cannot be automated away. Relying too heavily on technology to protect a company from fraud is a common mistake and can create a false sense of security.

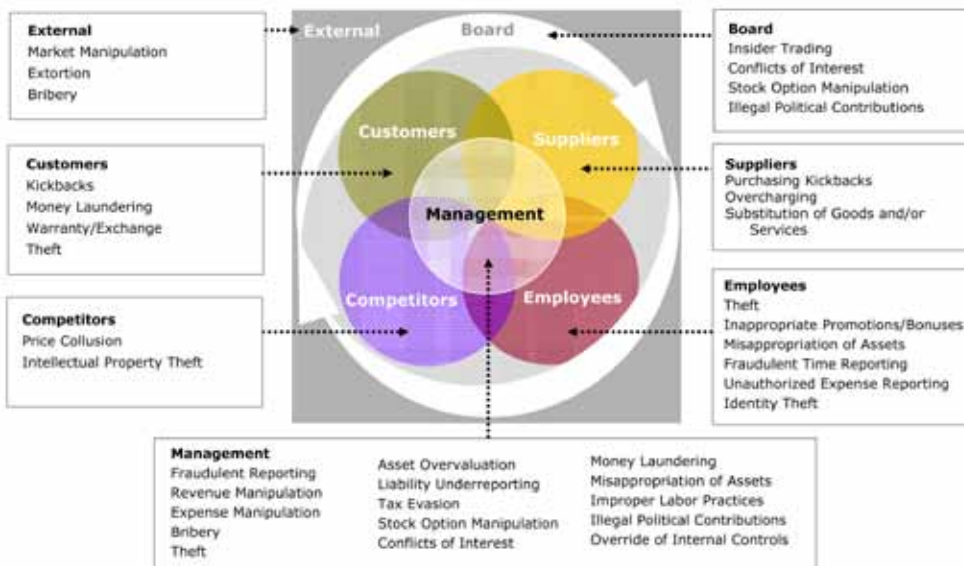
The chameleon-like nature of fraud requires organizations to employ a dual approach, one that addresses not only the actual opportunity threat of fraud but also the less tangible, more emotive threats of pressure, competence, rationalization, and arrogance. All preventive measures must be instituted top-down, starting with the CEO, and integrated into every business process, every employee task, and every training module corporationwide. In this way, employees can see how fraud controls relate to what they do every day, making it more difficult for employees to rationalize away control procedures or skip processes that would reduce the risk of fraud.

## Solutions

Management can use the following three steps to design a program to offset opportunities to commit fraud and the mindsets that can precipitate fraud.

1. Understand your unique risk universe (see exhibit below) and define the organization’s environmental risk baseline.
2. Build an antifraud program that focuses on controls that prevent fraud or detect fraud in a timely manner.
3. Phase in an appropriate fraud response management strategy.

### Defining Your Unique Fraud Risk Universe



### **Defining the Environmental Risk Baseline**

Environmental risk can be evaluated with a fraud risk assessment and a corporate culture survey. Both are designed to understand where and why fraud is most likely to occur, yielding a complete picture of a corporation's fraud risk, including staff attitude, propensity toward rationalization, and the extent of opportunity to commit fraud.

For most organizations, unidentified fraud schemes present the real danger. To fully appreciate where opportunity risk lies, a fraud risk assessment identifies where corporate activities are done. What functions are performed in which business units? What activities are outsourced, moved between trading partners, and transferred across borders?

Activities – especially corporate operations across borders – performed by the board of directors, top managers, employees, suppliers, customers, competitors, and external contractors are reviewed for fraud risk. As a result of this assessment, management could, for example, determine the likelihood that a contract-hire bribes, or has the opportunity to bribe, a foreign official. Based on the likelihood and likely impact of that incidence, management can then design and put into place the proper prevention and detection mechanisms to minimize risk associated with opportunity.

Obtaining a baseline for the other four fraud drivers – pressure, rationalization, competence, and arrogance – is trickier, but it is possible with a cultural assessment that gives management a window into the mindset of employees and their values and behavior. In addition, the cultural assessment can help identify the pressure points that could motivate employees to cross the line and push employee sentiment toward rationalizing fraud. Thorough assessments can also help evaluate the tone of an organization. That tone at the top influences the “control consciousness” of the senior management team and its perceived integrity, which employees are likely to emulate. An organization with poor tone or lax ethical oversight is more likely to be an environment favorable to fraud.<sup>9</sup>

Administered by an independent third party, an anonymous cultural assessment or survey poses probing questions that draw attention to risks and challenges facing the organization. Does an employee's immediate supervisor set an ethical example with regard to conduct? Do employees clearly understand the objectives for which they are responsible? Are employees' performance targets relevant and reasonable? If survey answers to these types of questions are skewed among the surveyed employees, it is unlikely that management has conveyed reasonable performance and cultural expectations to its employees. When such expectations are unclear, employees are more likely to rationalize fraudulent or corrupt behavior.

Together, the fraud risk and cultural assessments define a company's environmental risk. These assessments should be completed at least annually or whenever the organization undergoes significant changes, such as a merger or management shuffle.

### **Building an Antifraud Program**

Once an environmental risk baseline has been defined, senior management can add prevention and detection methods to head off fraud. Combinations of internal and cultural controls form the core of an antifraud program.

Internal controls limit the opportunity to hide the fraud trail and whittle away at the confidence to commit fraud of all but the most supremely arrogant employees. Common methods include security and access controls, such as dual authority or monetary transaction caps, as well as audits, inspections, and transaction monitoring. Care should be taken that internal controls remain consistent during reorganizations. Publicly traded companies should have an independent internal auditor to verify control procedures and financial performance and to report findings directly to members of the board.

Cultural controls promote an ethical environment and embolden employees to put a stop to fraud. Most organizations will find that a strong ethical environment will encourage self-policing, thereby increasing the level of oversight far beyond what internal control methods alone provide. Senior managers can use a companywide ethics policy to set a strong, consistent antifraud message at the top that defines enforcement procedures and consequences of fraudulent behavior. Safe avenues can be created for people to report questionable behavior, and employees should be rewarded for standing up for what is right. Compensation tied to realistic goals can alleviate employee pressure to perform.

These are just a few of the possible controls companies can put in place to minimize fraud risk. Well-run organizations will weigh costs of putting such controls in place against the relevant risk of fraud. In some cases, this exercise could bring to the surface opportunities to remove redundant or unnecessary controls.

### **Phasing in a Fraud Response Strategy**

Quickly heading off the fallout when fraud is suspected can minimize the possibility of a costly governmental investigation. Management should have in place processes to investigate, report, and monitor incidents of suspected fraud. By using the results of the environmental assessment, an appropriate strategy can be developed for dealing with specific types of fraud, corruption, and other misconduct. The protocol for reacting to an employee cheating on an expense report is different from that for an executive involved in manipulating revenue.

Employees should be familiar enough with corporate protocol to know where to turn when they suspect fraud. Impartial avenues, such as a third-party whistle-blower hotline, are the most effective way to ensure that employees are protected when reporting suspected fraud. Ongoing investigations should be reported to more than one person – a committee, the board, or others – to illuminate possible fraudulent activity taking place at a higher level of management. The chairman of the board might be responsible for overseeing an investigation of suspected fraud committed by the CEO, whereas a human resources executive might be responsible for investigations into staff expense reimbursement fraud.

## **Conclusion**

The days of willful blindness or claims that “we just did not know what was going on” are past. By building a program with appropriate prevention and detection measures and a management strategy of rapid response, senior management is able to create an antifraud program that can stand up to stakeholder scrutiny and the judicial process. Top-down directives, an independent audit committee, clear policies and procedures, ethics training, a well-designed whistle-blower hotline, competent and independent internal auditors reporting directly to the audit committee, frequent monitoring, and an attitude of healthy skepticism will assist in keeping these efforts center stage. The result: an antifraud program that is effective and sustainable over time, regardless of company performance and economic conditions.

## Contact Information

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<sup>1</sup>Russell Gold, "Halliburton to Pay \$559 Million to Settle Bribery Investigation," The Wall Street Journal, Jan. 27, 2009, p. B3.

<sup>2</sup>Ron Winslow, "Pfizer Sets \$2.3 Billion Settlement," The Wall Street Journal, Jan. 7, 2009, p. B2.

<sup>3</sup>Donald R. Cressey, "Other People's Money: A Study in the Social Psychology of Embezzlement," New York: Free Press, 1953.

<sup>4</sup>Kroll, "Global Fraud Report," New York: 2008.

<sup>5</sup>Association of Certified Fraud Examiners, "2008 Report to the Nation on Occupational Fraud & Abuse," Austin, Texas: 2007.

<sup>6</sup>FBI Director Robert Mueller's speech to the American Bar Association, April 17, 2008.

<sup>7</sup>Association of Certified Fraud Examiners, et al, "Managing the Business Risk of Fraud: A Practical Guide," 2008.

<sup>8</sup>For more corporate governance guidance, see Jonathan T. Marks, "Setting the Tone at the Top: Sustaining Ethical Behavior," Crowe Horwath LLP, 2009.

<sup>9</sup>The Committee of Sponsoring Organizations of the Treadway Commission (COSO), an alliance of professional accounting associations, released a groundbreaking study in 1987, "Report of the National Commission on Fraudulent Financial Reporting," that reported the causal factors that lead to fraudulent behavior. According to COSO, the tone at the top plays a crucial role in creating the control consciousness of an organization, one that is capable of leading employees to a higher ethical standard of conduct or a breeding ground for fraudulent activity.

