

SPECIAL SECTION

Financial and Economic Crisis

Keeping Corporate Fraud In The Cross-Hairs Tough Economic Times Can Lead Good People To Rationalize Inappropriate Behavior

Timothy P. Hedley
and Lesley D. Hand

KPMG LLP

Financial institutions have collapsed, many companies find themselves struggling to stay afloat, investors are pressing for stable returns and governments have stepped in to shore it all up. Without doubt, global economic conditions have put the corporate world under some of the most intense pressure in memory. Conditions become ripe for misconduct and fraud as this pressure meets opportunity. KPMG's 2008 Integrity Survey highlights this when it found 74 percent of U.S. workers surveyed witnessed misconduct on the job in the past year, and most blamed such activity on a corporate culture that promotes "do-whatever-it-takes" operating conditions.

HIGHLIGHTS

Law Firms

Gone In 60 Seconds – When Dealerships Go Bad, What's Their Lender To Do? Simon Kimmelman SILLS CUMMIS & GROSS LLP* Page 6

President Obama Signs Into Law The Credit Card Accountability, Responsibility And Disclosure Act Of 2009

Joy Harmon Sperling and David I. Schiefelbein DAY PITNEY LLP* Page 7

New Regulations Implementing The New York WARN Act Lawrence J. Baer and Kenneth P. Gavsie WEIL, GOTSHAL & MANGES LLP* Page 8

Department Of Energy Outlines Funding For Energy-Efficiency Efforts Michael A. Stosser, Elizabeth C. Barton and Jennifer E. Galiette DAY PITNEY LLP* Page 9

Some Of The Above Partner With Corporate Counsel By Providing Us With Financial And Editorial Support.

* Supporting Law Firms

The Fraud Triangle

When investigated, it is found that most corporate frauds include one or more dimensions of what is known as the fraud triangle: incentives/pressure, opportunity and attitude/rationalization. Logically, corporate executives and board members should continually assess whether or not the control environment adequately considers and addresses the elements of the fraud triangle.

• Incentives And Pressure

Intense pressure may stem from trying to operate profitably in an extraordinarily difficult economic climate or from age-old fear factors, such as the fears of failure, losing a bonus, poor performance, or job loss.

Self-imposed pressure can also occur, as in the case of an individual who championed a particular market strategy and then focused on "managing" financial information to avoid letting the company down, when results appear destined to miss expectations.

Consider also that amid the tumult of poor economic conditions and poor stock performance, there may be pressures to "manage" current earnings lower to build "a rainy-day fund" for future quarters.

• Opportunities

Incentives and pressures often represent the spark that can set fraud in motion, but there must be the opportunity. Opportunities to alter financial information are often open to people who directly touch accounting processes or who can influence how transactions are recorded.

Opportunities may exist when an

Timothy P. Hedley, 212-872-3496, and Lesley D. Hand, 415-963-7658, are Partners in the Forensic practice at audit, tax and advisory firm KPMG LLP. Hedley is based in New York, and Hand is based in San Francisco.

KPMG LLP, the audit, tax and advisory firm (www.us.kpmg.com), is the U.S. member firm of KPMG International. KPMG International's member firms have 137,000 professionals, including more than 7,600 partners, in 144 countries.

The views and opinions are those of the authors and do not necessarily represent the views and opinions of KPMG LLP. All information provided is of a general nature and is not intended to address the circumstances of any particular individual or entity.



Timothy P.
Hedley



Lesley D.
Hand

individual has the ability to distort reality by false or deceptive information. It can be accomplished, for example, by tweaking some area of subjective accounting, outright falsification of documents, and/or collusion with third parties.

For instance, reserve accounts (e.g., doubtful accounts, inventory reserves) can be adjusted to artificially low or high levels by distorting or fabricating facts. Some retail companies can move retail inventory items from one cost pool to another in order to increase or decrease gross profits. Detection often is difficult, especially in large retail companies with thousands of items in inventory. Detection is also difficult because it is basic human nature to trust your co-workers and management. Most of the time this trust is appropriate, but a healthy dose of skepticism can be a safety net.

• Attitude Rationalization

Most people have a moral compass that helps them avoid committing a crime. But individuals under pressure can also rationalize their behavior to justify their actions, allowing them to maintain the belief that they did not violate their own morals. Some well-known rationalizations include "nobody gets hurt," "nobody will notice," "I'm doing it for the good of the company," "this is the way business is done," or "it is just a timing thing so who cares."

Once people have made up their minds to rationalize, they become invested in the answer. It is important to constantly access and question subjective areas of accounting.

Red Flags And Pressure Points

Management and corporate boards, especially audit committees, must monitor for conditions that can trigger one or more legs of the Fraud Triangle as a key to fraud prevention.

• Loan Covenants

The pressure becomes obvious when operating results or key ratios approach loan covenant thresholds. Corporate

gate keepers should pay close attention to financial data that affects covenants, and monitor when corporate loans come due for renewal. What are the covenants? What are potential trouble spots? What reported numbers are most sensitive to change and how can they impact covenants? What situations can lead to financial manipulation?

• Liability Accruals

There have been situations where companies have earnings per share above market expectations, but choose to report lower EPS to match competitors. This allows the company to establish a rainy-day reserve. An audit committee should inquire about unusual or unexpected changes in operating results, liabilities or subjective contra accounts (i.e., positive or negative). An added proactive step is to ask for after-the-fact monitoring reports to establish if management's estimates are reasonable.

• Subjectivity In The Balance Sheet

To understand how susceptible data is to manipulation, directors should consider drilling down on subjective balance sheet accounts and their underlying assumptions and key drivers. Corporate overseers should monitor valuation allowances, assumed rates of returns on pension assets, processes to value illiquid assets, contingency accruals and environmental reserves. It is often helpful to think about this account movements in subjective areas in the context of what it takes to move EPS.

• Revenue Recognition

It is helpful if corporate overseers understand how sale transactions can be manipulated. When is a sale a temporary revenue-generating slight-of-hand that will come back for credit? Credit memos can provide indications of abuse. Credit memo activity reviews should occur throughout the year, and it may help to graph them to look for patterns.

"Bill and hold" transactions have very specific tests that need to be met in order to record revenue. Specific controls and monitoring should be in place to ensure appropriate timing of revenue recognition. Large or unusual transactions near the end of a quarter should be flagged for specific review to be sure that revenue recognition criteria are met.

Audit committees should inquire about "round-trip" transactions and ask

“Defensive Efforts”

Continued from page 11

Joining a slew of trial lawyer bills that sought to increase recoverable damages and otherwise expand liability under state consumer protection law, increase liability for tortious death or injury of pets, raise the limits on noneconomic damages in wrongful death litigation, and unduly expand the state’s False Health Claims Act. The lead paint bill failed to pass before the legislature adjourned.

New York

Though the Empire State’s economy is in shambles and Albany is awash in red ink, many state lawmakers there, led by personal injury lawyer and Assembly Speaker Sheldon Silver, have nonetheless seen fit to push litigation legislation that can only drive more businesses to bankruptcy and more jobs out of state.

Arguably the most onerous of several such bills are A. 8646 and S. 5768, companion bills still pending in respective Assembly and Senate committees at press time. The legislation would create a new private right of action under the state’s securities law known as the Martin Act. Currently, only the state attorney general can bring lawsuits against mutual funds and other such financial entities for acts of negligence. This mind-boggling proposal would increase the statute of limitations to six years from the date of discovery but would not require plaintiffs to show “reliance” on the defendants’ conduct.

Michigan

Personal injury lawyers again managed to get their desired repeal of Michigan’s longstanding products liability defense for makers of federally approved prescription drugs through the House in Lansing this year. But like last year, the radical bill, H.B. 4316, appears to have stalled in the Senate where cooler heads understand that the mere introduction of such legislation in previous years has already cost the economically ravaged state thousands of 21st century jobs.

Illinois

The Land of Lincoln is sometimes derisively referred to as the Land of Lawsuits, and for good reason. With Cook, Madison and St. Clair counties routinely cited in ATRA’s annual Judicial Hellholes report, it should come as no surprise that trial lawyer lobbyists are a formidable presence in Springfield.

But with the state’s entire political universe currently consumed by a gaping budget deficit and the desire to enact good-government reforms in the wake of former Gov. Rod Blagojevich’s federal indictment, the list of litigation legislation was relatively short. The most threatening bill, S.B. 184, would have awarded prejudgment interest to accrue from the date a defendant was served with written notice of a claim for damages. To his credit, the bill’s chief sponsor, Sen. William Haine, withdrew the bill when representatives of the Illinois Civil Justice League and others explained how it could work to coerce defendants into unjust settlements and

otherwise help drive businesses and jobs from the state.

Wisconsin

In the case of the Badger State, it wasn’t lawmakers with whom trial lawyer lobbyists had the most success. Rather it was Gov. Jim Doyle who was convinced to hijack the state budget bill, A.B. 75, by inserting unrelated provisions that, among other things, would have reinstated joint and several liability for defendants found to be less than 51 % at fault, as long as the defendant’s fault exceeded that of the plaintiff.

Doyle’s proposal would have allowed plaintiffs’ attorneys to target minimally liable defendants with deep pockets. Wisely, both the Assembly and Senate removed the governor’s handiwork from the budget bill before final passage.

California

Like New York, only much worse, California is facing an unfathomable record budget deficit and losing businesses, jobs and productive residents hand over fist. Yet certain lawmakers in Sacramento remain beholden to the trial bar and persist with a litany of liability-expanding legislative proposals, any and all of which can only expedite the formerly Golden State’s pending financial collapse.

One such bill that made it all the way to Gov. Arnold Schwarzenegger’s desk before being terminated by his veto pen would have indefinitely lengthened the statute of limitations on fair pay claims. (WARNING: Legislators in many statehouses are now determined to move similar state versions of the federally enacted “Lilly Ledbetter Fair Pay Act.”)

As noted above, not all state trial lawyer bills were defeated this year. Here are a few that have or probably will become law:

California

Staying in California, observers in Sacramento suggest at press time that Gov. Schwarzenegger is likely to sign into law a pending bill that would ban the use of the chemical bisphenol A (BPA) in plastic baby bottles and formula containers, even though the U.S. Food and Drug Administration, the European Union and the Canadian government, among others, have found use of the chemical to be safe. Since California is already home to at least 14 of the 29-and-counting BPA class action lawsuits filed nationally, most of which make no claims of actual injury, expect a new rush of litigation as prospecting trial lawyers look to strike it rich.

Oregon & Washington

Moving up the Pacific Coast, both Oregon and Washington have attracted increasing attention from the personal injury bar in recent years. This year the two states’ legislatures were inundated with dozens of liability-expanding bills, and the trend is expected to continue. If there’s any good news, it’s that trial lawyer lobbyists only got one such bill enacted into law in each state in 2009: steadily increasing tort liability limits through 2014 in Oregon, and a broad expansion of state consumer protection law with plenty of new incentives for tort lawyers in Washington.

Iowa

Turning inward to the heartland, Iowa caved in to become the last state in the union to provide a private right of action in otherwise expanding its own consumer protection law, which, incidentally, contains vague definitions of fraud and does not require a plaintiff to prove that the defendant intended fraud.

As noted above, the litigation industry is relentless and can be expected to increase its legislative branch lobbying efforts next year. ATRA’s own Defensive Efforts campaign will work to counter the trial bar. For information about how you can help and the latest legislative updates, visit ATRA’s specialized and publicly accessible website, www.defendingtortreform.com.

Corporate Fraud

Continued from page 5

internal audit to compare customers’ and vendors’ names and to review unusual transactions between them.

• Management Micromanaging

Pay close attention when executives with a hands-off management style suddenly take a particular interest, especially in routine transactions or when a large deal is critical to meeting objectives. Audit committees can gain insight by asking questions of management, corporate counsel, internal audit, and the external auditors.

Audit committees should fully understand business strategies and rationalizations for current acquisitions in this difficult environment, especially

if debt financed. Companies that depend on acquisitions to achieve revenue and/or other earnings targets could face intense pressures when the market turns lower.

Practice Prevention

While current economic conditions can foster fraudulent behavior, companies can deter it by implementing appropriate prevention, detection and response plans. And when senior executives promote an ethical tone at the top environment, such plans can set an expectation for employees to do the right thing in the right way.

It is critical in difficult economic times for the corporate overseers to understand a company’s financial health and where the enterprise is susceptible to fraud. After all, what you don’t know is what gets you in trouble.

Please email the authors at thedley@kpmg.com or lhand@kpmg.com with any questions about this article.

Partners Notes

Protiviti’s Enhanced GRC Solution Enables Sustainable Compliance Management

Protiviti Inc., a global business consulting and internal audit firm, announced the release of the Governance Portal™ version 3, a software solution to manage governance, risk and compliance (GRC). The Governance Portal integrates Protiviti’s proprietary content and consulting expertise with commonly accepted governance frameworks to establish a comprehensive platform that gives organizations the visibility and insight they need to manage and mitigate critical risk and compliance issues.

The latest release of the Governance Portal enables all key elements of a GRC program, including the following:

- Management can define the appropriate policies and procedures and then map them across the enterprise to understand the impact of policy changes and to drive certification.

- Risk and control self-assessments support real-world scoring techniques that help organizations consider both quantitative and qualitative drivers of risk, including financial loss, business continuity, regulatory impact, reputational exposure and human resources.

- An integrated survey feature makes it easy to involve stakeholders – including employees and suppliers – in the assessment process while continuously updating underlying elements of the risk and control framework.

- An event and loss management capability facilitates the collection of

actual, external and virtual loss data and supports integration with third-party source systems. Loss data can be recorded in local currency and converted to the base currency based on historical exchange rates.

- Key indicators enable organizations to measure both performance and risk, giving them more confidence to aggressively pursue their corporate objectives while still managing risk.

- The audit management capability includes enterprise risk assessment, scheduling and resource management, execution, reporting and monitoring/follow-up. Auditors are also able to complete fieldwork while disconnected from a server or the Internet. Audits are performed against the central risk and control register while allowing auditors to secure their detailed audit work. This interaction contributes to management’s overall GRC perspective while maintaining independence of the audit.

- Issues and action plans are contributed to a central repository from all GRC communities within the organization, thus providing a single platform for managing all findings across the enterprise.

- A reporting engine provides management with an integrated outlook for decision making that balances performance with assessment of risks.

For more information visit www.protiviti.com.