

executive report

70  
YEARS OF THOUGHT LEADERSHIP



**ferf**

financial executives  
research foundation

sponsored by

**RR DONNELLEY**

# BREAKING THE CYCLE OF FRAUD

WHAT SENIOR FINANCIAL  
EXECUTIVES SHOULD DO

# TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	2
CYCLE OF FRAUD – CASE STUDIES .....	4
HOW TO BREAK THE CYCLE.....	9
SURVEY RESULTS .....	15
WHAT DO THE SURVEY RESULTS TELL US? .....	17
CONCLUSION .....	18
APPENDIX A: FRAUD CASES.....	19
ABOUT THE AUTHORS .....	24
ABOUT RR DONNELLEY FINANCIAL SERVICES .....	25
ABOUT FINANCIAL EXECUTIVES RESEARCH FOUNDATION .....	26

*“The thing that causes people to cross over and start doing inappropriate accounting is rationalization. ...The goal is to discipline yourself not to rationalize inappropriate accounting, such as finding the grey area, which is the thing that causes people to cross over ...[Organizations] have to make integrity and honesty a part of the corporate culture. Employees want to please their boss, but if their boss is not sending out the message that ethical behavior is as important as making their numbers, that is how it gets off track...”* Aaron Beam – Former CFO, Healthsouth, speaker and author, HealthSouth: The Wagon to Disaster and The Ethics Playbook: Winning Ethically in Business

# Executive Summary

Over the years, the United States has experienced a cycle of corporate frauds, followed by commissions and inquiries, followed by implementation of new legislative and regulatory requirements that, in turn, are followed by similar reoccurring frauds. While it is not expected that legislation and regulation can prevent fraud completely, the onus remains with an organization to explore what can be done to reduce its risk of fraud.

This Financial Executive Research Foundation (FERF) report reviews recent major fraud cases to highlight the similarities of what transpired, how these frauds were detected, and what was done in response. In each case, these frauds were addressed with legislation or regulations that focused primarily on internal controls and auditing processes.

In 1992, for example, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its *Internal Control-Integrated Framework*. As businesses became more complex, more technology-driven and more global, recognized need emerged for an updated framework. As a result, COSO developed *Internal Control-Integrated Framework 2013* (the 2013 COSO Framework), which replaced the 1992 Framework as of December 15, 2014.

Similarly, in 2002, in response to the major frauds occurring in the late 1990s through 2002, Congress passed the Sarbanes Oxley Act (SOX). SOX expanded on earlier legislation and attempted to reduce future frauds by addressing auditor independence, corporate responsibility, enhancing financial disclosures and penalties for white collar crime, and setting new standards for management assessment of internal controls (Section 404).

This report also discusses the importance of the **Fraud Triangle** in managing the risk of fraud. The Fraud Triangle states most frauds contain three elements (or three legs of the triangle): Financial Pressure, Opportunity, and Rationalization. In the past, there has been much focus on managing Opportunity by strengthening internal controls, but less focus on Financial Pressure and Rationalization. However, the COSO 2013 Framework places a focus on the Fraud Triangle in the Risk Assessment Component discussed in Principle 8.

Finally, this report compiles and analyzes survey results conducted of financial executives, managers, and staff to identify and evaluate the measures being followed by their companies to mitigate the risk of fraud. In addition, participants provided recommendations to improve fraud avoidance and detection.

The key findings and recommendations of this report are:

1. **Tone at the top and corporate culture is critical!** Employees are aware of their executives' and/or board of directors' actions, and influenced positively by those who “walk the walk and talk the talk.” Executives who establish a strong ethical tone and culture set the stage for the ethical behavior of their employees.
2. Ethics programs should understand and address all three legs of the fraud triangle: Opportunity, Financial Pressure, and Rationalization.
  - a. Opportunity: Continue to implement and monitor a strong system of internal controls while adopting realistic programs to periodically assess its efficiency.
  - b. Financial Pressure: Uphold corporate culture as set by leadership of senior management and “tone at the top”.
  - c. Rationalization: Maintain a strong corporate culture that stresses integrity and ethics. Corporate culture should be supported by an effective ethics training program that provides real-world examples of ethics lapses, fraud, and rationalization, and the consequences to those who committed fraudulent behavior.
3. Financial executives, management and staff believe and recommend that leaders of all companies, whether publicly or privately held, should adopt a strong fraud prevention and ethics training program in conformity with the recommendations below.
4. Ethics training programs need to be presented at least annually and are more effective when conducted in “live” in-person training sessions, and/or training that is tailored to situations that employees may actually encounter. And equally as important, the training should be continuous.
5. An effective whistleblower program is extremely important to the success of fraud detection. If a whistleblower program does not exist, one needs to be implemented. The program must explain how employees should report their suspicions.
6. For a whistleblower program to be effective, the program and the assurance of no retaliation need to be communicated to employees throughout the year.



# Cycle of Fraud – Case Studies

A survey by Kroll<sup>1</sup> shows that from 2012 to 2013, 66 percent of the companies in the United States were affected by fraud (compared to 60 percent affected by fraud from 2011 to 2012). During the same time period the percentage of companies in the U.S. exposed to fraud has increased, growing from 66 percent in 2011-2012 to 81 percent in 2012-2013.

The matrix on page 6 summarizes a few major fraud cases over the years. It presents similarities in the primary causes of the frauds, the key perpetrators (usually from the C-suite), how the frauds were detected, what legislation or commissions were formed to address the frauds, and what changes were made by the legislation or commissions. This matrix shows the similarities in the underlying frauds, regardless of changes made (i.e., regulation, formation of commission, and issuance of new framework or legislation). There appears to be an unbroken cycle of frauds, detection, legislation and regulations, followed by more of the same. A detailed description of each of these cases is presented in Appendix A.

Evaluating these cases using the Fraud Triangle revealed financial pressures were caused by expectations to meet earnings, to grow revenue or earnings, or to remain solvent. All were caused by the chief corporate officers, who put pressure on others in the organization to participate in committing fraud, which is a clear case of a negative “tone at the top.”

Each case seemed to occur where there were weak or ineffective internal controls that provided the Opportunity for the fraud. Most involved managed earnings through manipulation of inventories and/or receivables, creating fraudulent entries or schemes to record revenues, or devising schemes to keep debt off the books. Rationalization was evident in each case - that what was being done was not wrong, or that it was temporary and would be fixed as soon as they worked their way out of the current problems.

Most of the frauds were detected either by a whistleblower or by the fraud becoming so large that it could not be sustained, usually in a recessionary economy. And in all the cases, the response to the fraud included creating commissions and inquiries that led to legislation and regulations that called for strengthening internal controls and strengthening auditing processes.

---

<sup>1</sup><http://fraud.kroll.com/region-overview/united-states/>

Even as this paper is being written, similar new frauds are being reported every day. For example, news reports on December 18, 2014, reported that a former Rite Aid executive has agreed to plead guilty to a 9 year, \$14.6 million inventory fraud scheme.<sup>2</sup>

Also, subscribers of SEC enforcement actions receive daily emails of investigations and/or enforcement actions by the SEC. These offenses, also repetitious, range from insider trading to accounting violations, with the majority resulting in prison time and/or large monetary penalties. The increase in these enforcement actions is a direct result of whistleblower legislation (such as Dodd Frank Act of 2010 and SOX) and regulation (amendments to the SEC Act of 1934).

Therefore, to break this cycle and reduce the number and the magnitudes of fraud, something different must be done. This paper examines what financial executives should be aware of and should encourage their companies, whether publicly or privately held, to implement in the way of programs and training to implement best business practices when it comes to managing fraud prevention.



---

<sup>2</sup><http://finance.yahoo.com/news/ex-rite-aid-vp-charged-195848378.html>

Year	Company	Primary Fraud	Key Perpetrator(s)	Detected By	Legislation/Commission	Changes Made
1939	McKesson & Robbins	Managing earnings with fraudulent inventory, fraudulent receivables	President of the Company	Whistleblower	SEC/AICPA	SEC Codification of Auditing Standards, Required Confirming Accounts Receivable and Observing Inventories
1973	Equity Funding	Managing earnings with fraudulent insurance policies, off balance sheet liabilities	Chairman and CEO and 22 other executives	Whistleblower - Fired Employee	Foreign Corrupt Practices Act of 1977	Required corporate management to establish and maintain system of internal controls
1982	ZZZZ Best	Managing earnings with fraudulent revenue entries and fraudulent receivables used to support fraudulent borrowing	Owner and President of the Company	Whistleblower - Former Customer	Treadway Commission 1985-1987	Led to formation of COSO and the 1992 <i>Internal Control-Integrated Framework</i>
1989	MiniScribe	Managing earnings with fraudulent inventory, fraudulent receivables	CEO, CFO and other members of management	Collapse of the business due to fraud becoming too large to manage	COSO's 1992 <i>Internal Control-Integrated Framework</i>	COSO's <i>Internal Control-Integrated Framework</i> 1992 became widely accepted by corporations in assessing and evaluating their internal controls
1997	Cendant	Managing earnings with fraudulent liabilities	Chairman, CEO, CFO, and 4 senior finance managers	Collapse of the business due to fraud becoming too large to manage	Sarbanes-Oxley Act 2002 (SOX) and PCAOB	SOX addresses auditor independence, corporate responsibility, enhanced financial disclosures, enhanced penalties for white collar crime, and new standards for assessment of internal controls. Established the PCAOB to oversee the audits of publicly held companies.
2001	Enron	Managing earnings with fraudulent liabilities	Chairman, CEO, and CFO	Collapse of the business due to fraud becoming too large to manage, a slowing economy and an internal whistleblower		
2002	WorldCom	Managing earnings with fraudulent liabilities and fraudulent revenue entries	CEO, CFO, Controller, and Director of Accounting	Internal Whistleblower - the VP of Internal Audits		
2008	Lehman Brothers	Managing earnings with fraudulent liabilities and fraudulent revenue entries	CEO and CFO	Cash shortages led to bankruptcy which led to investigators finding the fraud	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	Emphasis on financial securities and institutions but also requires changes in corporate governance for all publicly held companies including amendments to PCAOB
2012	Groupm	Managing earnings with fraudulent liabilities and fraudulent revenue entries	Senior Financial Management	Auditors	COSO <i>Internal Control - Integrated Framework</i> 2013	COSO's <i>Internal Control - Integrated Framework</i> 2013 is a result of all the changes and complexity added since 1992

# FRAUD AND THE FRAUD TRIANGLE

There are two broad categories of business fraud: 1) enriching individuals (stealing from the organization); and 2) misleading investors (corporate fraud). While both types of fraud are very common in today's business world, this paper and its survey will focus on corporate fraud; although most of the findings of this paper relate to both types of fraud.

Both categories of fraud exhibit common characteristics that can be described by the Fraud Triangle. Two individuals who probably deserve the most credit for the Fraud Triangle model are early criminology researchers Edwin Sutherland and Donald Cressey.<sup>3</sup>

The Fraud Triangle is universally accepted in almost every setting in which fraud is described or analyzed. Cressey stated individuals are motivated to commit fraud when three elements come together: 1) some kind of perceived pressure; 2) some perceived opportunity; and 3) some way to rationalize the fraud as not being inconsistent with one's values.<sup>4</sup> These elements are also the fundamentals covered in SAS No. 99 (Consideration of Fraud in a Financial Statement Audit).

The Association of Fraud Examiners describes the Fraud Triangle as follows:<sup>5</sup>

The Fraud Triangle has three factors that are present in corporate frauds:

1. **Opportunity** (weak or nonexistent internal controls) – the situation that enables fraud to occur;
2. **Financial Pressure** (motive) – the perceived need for committing fraud; and
3. **Rationalization** (weak ethics) – the mindset of the fraudster that justifies them to commit fraud.



<sup>3</sup> <http://www.fraud-magazine.com/article.aspx?id=4294983342>

<sup>4</sup> <http://www.fraud-magazine.com/article.aspx?id=4294983342>

<sup>5</sup> Image from Association of Certified Fraud Examiners



An example of how the Fraud Triangle functions in a real life scenario would be the Bernie Madoff Ponzi scheme:

*“When analyzing the fraud triangle elements with regards to the Bernie Madoff Ponzi scheme, it is clear that opportunity existed because he was the head of the company. Although others had suspicions, no one seriously questioned him, allowing his scheme to go on for years. The motivation behind the fraud was to continue to make the company look successful in order to gain more clients and allow his vast personal income to continue. However, Madoff was forced to forfeit \$170 million in personal assets following his criminal trial. Madoff may have rationalized that the investors were at least getting their returns for now and he would be able to reach the reported assets eventually, so why destroy the company when it could be resolved in the future. That was very unlikely though, considering what was a nearly \$50 billion difference between actual and reported assets.”<sup>6</sup>*

The Fraud Triangle illustrates that it is not only Opportunity – managed by internal controls - that needs to be addressed in managing the risk of frauds. The other two legs of the triangle: Financial Pressures and Rationalization also need to be addressed. These two legs are best addressed by integrity, ethical behavior, and corporate culture.

In the recent refresh of the COSO Framework of 2013, as part of the *Assessing Fraud Risk Component*, Principle 8 explicitly introduces the Fraud Triangle and suggests a company must consider the three legs of the Fraud Triangle in its risk assessment as follows:

1. Considers Various Types of Fraud – The assessment of fraud risk considers fraudulent reporting, possible loss of assets, and corruption resulting from the various ways fraud and misconduct can occur.
2. Assesses Incentive and Pressures – the assessment of fraud risk considers incentives and pressures.
3. Assesses Opportunities – the assessment of fraud risk considers opportunities for unauthorized acquisition, use, or disposal of assets, altering of the entity’s reporting records, or committing other inappropriate acts.
4. Assesses Attitudes and Rationalizations – the assessment of fraud risk considers how management and other personnel might engage in or justify inappropriate actions.<sup>7</sup>

---

<sup>6</sup> Kennedy, Kristen *An Analysis of Fraud: Causes, Prevention, and Notable Cases*

<sup>7</sup> [http://mcgladrey.com/content/dam/mcgladrey/pdf/wp\\_coso\\_2013\\_internal\\_control\\_integrated\\_framework.pdf](http://mcgladrey.com/content/dam/mcgladrey/pdf/wp_coso_2013_internal_control_integrated_framework.pdf)

# How to Break the Cycle

To break the fraud cycle, it is necessary to address all three sides of the Fraud Triangle when assessing the risk of fraud, and mitigating those risks within an organization.

## Opportunity

Opportunity is the side of the triangle that an organization can best control. Opportunity to commit fraud within an organization exists when there are weak or ineffective internal controls in place. As the business environment is not static, an organization should assess the strength and effectiveness of its internal controls on a regular basis (at a minimum, annually) using a tool like the COSO 2013 Framework.

To assist with the assessment of risk of fraud, ACFE's<sup>8</sup> 2014 Report to the Nations on Occupation Fraud and Abuse identifies three common areas where fraud has occurred: asset misappropriation, corruption, and financial statement fraud. Each area contains a subcategory and further subcategories. The chart below provides a snippet of the **Fraud Tree** that can be seen in ACFE's full report.<sup>9</sup>

Category	Sub-category
<b>Corruption</b>	<ul style="list-style-type: none"><li>• Conflicts of Interest</li><li>• Bribery</li><li>• Illegal Gratuities</li><li>• Economic Extortion</li></ul>
<b>Asset Misappropriation</b>	<ul style="list-style-type: none"><li>• Cash</li><li>• Inventory and all other assets</li></ul>
<b>Financial Statement Fraud</b>	<ul style="list-style-type: none"><li>• Asset/Revenue Overstatement</li><li>• Asset/Revenue Understatement</li></ul>

As each organization tailors its internal controls to its specific risk tolerance, the frauds mentioned above should be considered within the risk assessment.

<sup>8</sup> Association of certified Fraud Examiners

<sup>9</sup> <http://www.acfe.com/rtnn/docs/2014-report-to-nations.pdf>

## Financial Pressures

As revealed in the case studies above, there are instances where meeting analyst's expectations or the pressure to meet compensation and incentive bonus targets are far more important to senior management than ethical conduct. In these situations, members of senior management and their employees will be more predisposed to commit fraud. The proverbial quote resonates: "Boss, I will make the target even if I have to lie about it."

If senior management is more concerned with meeting financial goals than promoting ethical behavior, employees will follow suit - creating a negative tone at the top trickles down throughout the organization.

### **The importance of a positive "Tone at the Top"**

Tone at the top is the starting point for "the ethical atmosphere that is created in the workplace by the organization's leadership. Whatever tone management sets at the top will have a trickle-down effect on employees of the company. If the tone set by managers upholds ethics and integrity, employees will be more inclined to uphold the same values. However, if senior management appears unconcerned with ethics and focuses solely on the bottom line, employees will be more prone to commit fraud because they feel that ethical conduct is not a focus or priority of the organization."<sup>10</sup>

Training programs<sup>11</sup> and Principle 1 of the 2013 COSO Framework, emphasize that **setting a positive tone at the top is essential for an organization's success**. Setting a positive tone can be accomplished by:

- ***Leading by Examples on Matters of Integrity and Ethics*** – Members of an organization model themselves after their superiors. Participants of the FERF's ethics survey indicated their ethics training is effective because of a "tone at the top," "strong leadership support," and "support by top management and stockholders."

---

<sup>10</sup> [http://www.acfe.com/uploadedFiles/ACFE\\_Website/Content/documents/tone-at-the-top-research.pdf](http://www.acfe.com/uploadedFiles/ACFE_Website/Content/documents/tone-at-the-top-research.pdf)

<sup>11</sup> Presentation by the AICPA & ACFE

- ***Be clear and communicate ethical goals throughout organization*** – This communication can be accomplished through organizational policies and procedures and a strong code of conduct. During a speech at the SEC, then-Commissioner Roel C. Campos spoke about ethical behavior within an organization by stating “...it is not enough for reporting companies to simply have a code of ethics. No matter how well or beautifully the language of the code of ethics reads, if the code is relegated to the back of the policy manual or a cluttered website, it is of no use. I submit that having a code of ethics that is not vigorously implemented is worse than not having a code of ethics. It smacks of hypocrisy.” He continued his speech by urging chief executive officers (CEOs) and senior management “to live and practice on a daily basis the principles contained in their code of ethics.” He avowed that “good business” comes in the form of selection of CEOs and presidents largely based on their integrity and commitment to ethical behavior and equally as important as selection of these individuals, is the continued ethics education and training for future generations.<sup>12</sup>
- ***Rewarding appropriate behavior*** – Instead of heavily incentivizing employees on financial goals and targets, implement offsetting ethics-based performance appraisals. Include this ethics-based performance measurement within performance evaluations, promotion criteria, calculation of employee bonuses, or nonmonetary compensation. Do not be afraid to take corrective actions to those who deviate from the corporate conduct.<sup>13</sup>
- ***Participatory management*** – Board of directors and senior management must “walk the walk and talk the talk.”

---

<sup>12</sup> <http://www.sec.gov/news/speech/spch593.htm>

<sup>13</sup> Bolt-Lee, Cynthia E. and Moody, Janette Highlights of Finance and Accounting Ethics Research Oct. 14 – Journal of Accountancy

## Rationalization

The Rationalization leg of the fraud triangle occurs when an employee believes that what they are doing is not wrong, or that they are only following orders to keep their job, or that what they are doing will only be done this one time to “fix a current problem” and that it will be corrected in the future. In each of the case studies examined in this paper, perpetrators rationalized their fraudulent behavior as not being wrong or that it was temporary, and they would fix it as soon as they worked their way out of their current problems.

Rationalization is addressed with a strong corporate culture that stresses honesty, integrity and ethical conduct implemented with the goal of “limiting an individual’s ability to rationalize fraudulent activities.<sup>14</sup>” A strong corporate culture will help an employee understand and recognize situations and the consequences of “rationalization” and try to avoid this type of behavior.

### **The importance of Corporate Culture**

*“Every company has a culture either by design or by default”*

Dr. Larrv Senn

Corporate culture is a culmination of the other two legs of the Fraud Triangle. The Fraud Resistant Organization report states, “Studies show that organizations that encourage ethical behavior are more resistant to misconduct of all kinds, including financial reporting fraud....In an ethical culture, pressure to commit fraud is counteracted through sound risk management strategies and appropriate incentives.<sup>15</sup>”

“Employees do not intentionally join an organization to commit fraud,” but corporate culture may lead to unethical behavior – and employees ultimately rationalizing their actions. Therefore, an assessment of the conditions of a corporation should be made to determine what may lead an honest employee to become dishonest. <sup>14</sup>

---

<sup>14</sup> Anti-Fraud Collaboration *The Fraud-Resistant Organization, 2014*

<sup>15</sup> <http://www.thecaq.org/docs/anti-fraud-collaboration-report/the-fraud-resistant-organization.pdf?sfvrsn=2>

In addition, instilling an ethical corporate culture can also be supported by:

- **An effective ethics training program** - that provides real-world examples of ethics lapses, fraud, and rationalization and the consequences for those who do rationalize fraudulent behavior. This training should include knowledge of the company's code of ethics and job-specific scenarios. Survey participants that did not currently have ethics training, they believed it was important to begin some type of training. Those who had effective training, thought they should have more. Many suggested that tailored training is most effective.
- **Annual Surveys** – feedback from employees is always helpful to get insight about whether the message management sends is being received.
- **Whistleblower programs** – Whistleblower programs are a proven way to demonstrate the corporation will not tolerate fraud. A majority of the respondents to our survey believed the most common way unethical behavior is uncovered is through employee whistleblower hotlines. This belief is validated in a survey by the Association of Certified Fraud Examiners' 2014 Report to the Nations on Occupational Fraud and Abuse, which yielded similar results (40 percent). Employees, however, may have a difficult time reporting internally because they:
  - Don't believe corrective action will be taken to their complaint;
  - Don't believe their complaint will not be confidential;
  - Fear retaliation from their supervisors or their co-workers; and/or
  - Don't know who to contact. <sup>15</sup>

Regulations, such as the Dodd Frank Wall Street Reform Act and SOX, which incentivize and protect informants, have increased whistleblower activity. In a speech by SEC Chairman Mary Jo White at the Securities Enforcement Forum, Washington D.C., October 9, 2013, she discussed the SEC whistleblower program:

“As you know, the SEC’s whistleblower program allows us to give monetary rewards for valuable information about securities law violations. And, it has rapidly become a tremendously effective force multiplier, generating high-quality tips and, in some cases, virtual blueprints laying out an entire enterprise, directing us to the heart of an alleged fraud.”<sup>16</sup>

However, a report by the NBES of the US workforce revealed that most whistleblowers are not necessarily incentivized by incentives, but rather the obligation and desire to prevent harm.<sup>17</sup>

---

<sup>16</sup> Chair Mary Jo White, Remarks at the Securities Enforcement Forum, Washington, D.C., October 9, 2013.

<sup>17</sup> Report to the nations on occupational Fraud and Abuse

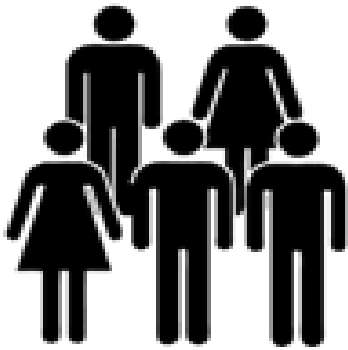
# Survey Results

To get input on areas that need to be improved to reduce fraud, FERF surveyed various levels of financial management and staff from senior level financial executives to staff accountants. Seventy nine people responded, including CFOs, controllers, heads of internal audits, and staff accountants. The findings include:

- Of the respondents, 53 percent of their organizations have ethics training programs; while nearly half, 47 percent, do not.
- Of those having a training program, 89 percent believe their company's training programs are effective and the majority does not believe their ethics training program should change.
- Respondents overwhelmingly think that what made their training programs effective was the "tone at the top," "strong leadership support," "support by top management and stockholders," "the message comes from the top." All comments supporting the corporate culture and tone at the top were discussed earlier in this report.
- Other comments about what made their training programs effective included "consistent communication," "based on our code of conduct," "using realistic examples," and "clear communication."
- Eighty three percent of respondents with ethics training programs indicated their programs include a discussion of internal controls. Forty percent are required to comply with SOX Section 404 and have adopted the 2013 COSO Framework.
- Most respondents believe SOX and the COSO Frameworks have been effective in preventing fraud and unethical behavior, with 57 percent stating they have been somewhat effective and 14 percent stating they have been very effective.
- Of those having a training program, 62 percent report the programs are conducted online while 22 percent report their training programs are conducted live by instructors.
- In a separate set of comments, respondents were asked, "What would you like to tell management about your ethics training?" Comments included: "Live training is better," "have it more often," "we don't have training and need it" and "it needs to be done at least once a year."



- A final set of survey questions dealt with how fraud and unethical behavior are caught. When asked what they believe to be the most effective way identifying unethical behavior, 46 percent selected whistleblowers; while 32 percent identify internal controls as being the most effective. These responses are similar to surveys conducted by other organizations and forensic accountants.<sup>18</sup>
- When asked if their company had a whistleblower program, 63 percent reported they did, and 31 percent reported they did not.
- Of those that have a whistleblower program, 56 percent believe their organization did enough to protect employees from retaliation if they become whistleblowers. Yet, in a separate question, 67 percent report they do not believe there would be retaliation if they became whistleblowers and reported unethical behavior.



89% believe their ethics training is effective

63% of organizations have a whistleblower program and 56% said that their whistleblower program did enough to protect employees from retaliation



<sup>18</sup> Report to the nations on occupational Fraud and Abuse

# What Do the Survey Results Tell Us?

## Internal Controls

Internal controls have a lot of visibility with SOX Section 404 and the COSO Internal Control-Integrated Framework 2013. Most respondents believe internal controls are effective in reducing unethical behavior and therefore a majority of organization responding have discussion about 2013 COSO Framework and/or SOX Section 404.

## Ethics Training

Only slightly more than half of the respondent's companies have ethics training programs. Those that do are most effective when presented live by instructors and when supported by a tone at the top that shows senior management support for ethics training. Respondents believe training is better when using realistic examples and should be consistent and frequent.

## Whistleblower hotlines:

Whistleblower programs are a way to demonstrate the corporation will not tolerate fraud and provide an effective way to detect fraud. Most respondents to our survey believed the most common way unethical behavior is uncovered is through employee whistleblower hotlines. One-third reported that their companies did not have a whistleblower program. Of those that did, more than half believed there would not be retaliation if they became whistleblowers and reported unethical behavior. Companies need to do more to establish and communicate their whistleblower programs and assure their employees they will be protected if they become a whistleblower.

# Conclusion

The Sarbanes Oxley Act of 2002 (SOX) and the related Public Company Accounting Oversight Board (PCAOB) provide stronger requirements for publicly held companies in the U.S. for assessing and implementing internal controls and monitoring auditing standards than any prior legislation or regulations. SOX and PCAOB also place more responsibility on corporate management and provide for stronger penalties for fraud than any prior act. However, corporate frauds are continuing and the ultimate effectiveness of SOX and the PCAOB in reducing fraud is still to be determined.

In issuing the 2013 COSO Framework, COSO reflects changes in the business world over the 20 years since the COSO 1992 Framework was issued. The 2013 COSO Framework enhances the assessment and implementation of internal controls, but also recognizes there is more to preventing and detecting fraud than just implementing strong internal controls. Both SOX and the 2013 COSO Framework recognize the need for addressing all three legs of the Fraud Triangle and the need to instill an ethical corporate culture and an ethical “tone at the top.”

The COSO 2013 Framework enhances and strengthens the five components in the 1992 Framework and adds 17 principles associated with these five components that are necessary for effective internal controls and fraud prevention. Of these 17 principles, the first principle (and the one this paper feels should be emphasized is) “The organization demonstrates a commitment to integrity and ethical values.”

This commitment to integrity and ethical values is best demonstrated with a strong, ethical “tone at the top” combined with a strong ethics training program and a strong whistleblower program that follow the recommendations in the Executive Summary to this paper.

# Appendix A: Fraud Cases

## McKesson & Robbins – 1939

McKesson & Robbins could be considered the “grandfather” of modern-day frauds in the U.S., not only because it was one of the first major corporate frauds that had a major impact in auditing standards but also because, in spite of the improvements made to auditing standards, the fraud perpetrated by McKesson & Robbins has been repeated at other organizations many times over the past 75 years.

McKesson & Robbins management, led by its president and his brothers, stole \$2.9 million over 12 years and misstated assets and earnings over that time by fraudulent recording of inventory and accounts receivable. The fraud was detected by reports from a whistleblower.

As a result of McKesson & Robbins, the SEC made recommendations to the AICPA that resulted in the first AICPA Codification of Auditing Standards including the requirement that auditors directly confirm accounts receivable and observe physical inventories.

## Equity Funding – 1973

Equity Funding was the first major fraud in the U.S. to use computers to help create and hide the fraud. The fraud was perpetrated by 22 executives and employees including the chairman and CEO of the company. Equity Funding inflated earnings by creating fictitious insurance policies which then were reinsured with other insurance companies. Equity Funding also borrowed funds that it did not record as liabilities. The fraud was detected by reports from a whistleblower.

Partially in response to Equity Funding, Congress passed the Foreign Corrupt Practices Act of 1977 (FCPA). The FCPA had two parts: one to make illegal any direct or indirect payments to foreign officials to influence obtaining of business and two, requiring that corporate management establish and maintain a system of internal accounting control that accomplishes certain general objectives.<sup>19</sup>

---

<sup>19</sup>Mautz, Kell, Maher, Merten, Reilly, Severance, and White. p. 2.

### ZZZZ Best - 1982

The story of ZZZZ Best is well-known. Barry Minkow, sole proprietor and a seemingly successful teenage entrepreneur, started a carpet cleaning business that quickly supported itself by check-kiting and then rapidly grew and went public with fraudulent receivables and revenues based on a fake insurance restoration business. Showing characteristics of both McKesson & Robbins (fake receivables) and Equity Funding (fake insurance revenues), this fraud was disclosed when a former customer became a whistleblower to local news media.

ZZZZ Best was one of the frauds in the early 1980s that led to the Treadway Commission's study in 1985 - 1987 on Fraudulent Financial Reporting, and in turn led to the formation of COSO and the COSO *Internal Control - Integrated Framework of 1992*.

### MiniScribe - 1987

MiniScribe was a manufacturer of computer hard disk drives. Facing earnings problems and an inventory "hole" created when an actual inventory count and dollar value were less than what was recorded on MiniScribe's financial books, the CEO, CFO, and other members of management fraudulently created inventory by buying bricks and boxing them in boxes that were presented to the auditors as inventory of hard disk drives. Over a two-year period, inventory was overstated by \$15 million and earnings were overstated by \$22 million as a result of the fraudulent accounting entries and fraudulent inventory. The fraud was detected when it became too difficult for management to manipulate the lack of real inventory and when the stock market collapse of October 1987 forced MiniScribe into bankruptcy.

While the collapse of MiniScribe came after the Treadway Commission it was a part of the frauds that had recently occurred when COSO issued the *Internal Control - Integrated Framework of 1992*. Also note the similarities to MiniScribe and the fraudulent inventory in McKesson & Robbins in 1939.

### Cendant - 1997

Cendant was formed in 1997 with the merger of HFS Incorporated, owner of well-known franchise brand hotels, car rental agencies and real estate brokerages, and Comp-U-Card (CUC) a membership based consumer services company. Cendant's executives including the chairman, CEO and four accounting officials including the CFO, corporate controller, vice president of accounting and reporting, and director of financial reporting, perpetrated a fraud that included many schemes including fraudulently establishing merger reserves that were later used to manipulate earnings and manipulating membership service's revenue and related liability accounts. Many of these schemes seem similar to those used by Equity Funding to create fictitious insurance policies. It is unclear how the SEC

became aware of the fraud at Cendant, but it appears it had grown so large as to have become unmanageable.

While there was no direct legislative or regulatory action taken as a result of Cendant, it was, at \$2.85 billion, the largest securities law settlement to that time. And it was the precursor of Enron, WorldCom and the other frauds that led to the Sarbanes Oxley Act of 2002.

### Enron – 2001

Enron was created in 1985 through a merger of natural gas companies InterNorth, Inc. and Houston Natural Gas Corporation. The company grew rapidly with the deregulation of the sale of natural gas and diversified quickly into other energy investments including electricity plants, paper and pulp plants, water plants, broadband services, and creation of online energy trading websites. Many of these investments were structured as partnerships. Many of these partnerships had losses and incurred debt that Enron did not want to report on Enron's financial statements.

In this climate of pressure for growth and earnings, Enron executives became creative on how to manage earnings and how to remove losses and debt from Enron's financial statements. What resulted were very complex financial statements that were confusing to investors and analysts. The complexity of the financial reporting included schemes devised by the executives to treat the investment partnerships as Special Purpose Entities (SPEs). SPEs were designed to hide losses, create cash inflows for Enron and remove debt from Enron's books. Initially these SPEs were in compliance with existing generally accepted accounting principle (GAAP), as risk was passed from Enron to the SPE.

However, as losses grew, assets lost value, and debt payments had to be paid, the SPEs took on more risk that was shared by Enron that led to the off-balance sheet accounting for SPEs to no longer be in compliance with GAAP. Even though the accounting for the SPEs was no longer in compliance with GAAP, Enron continued to report the SPEs as they had when they were in compliance with GAAP. This resulted in Enron filing misleading, fraudulent financial statements that hid losses and debt until the losses and debt became so massive.

In the late 1990s, the stock market was in decline and the economy had slowed. However, Enron continued to do more and more deals. This contradiction between what Enron was reporting and what the rest of the economy was doing, got the attention of investors, analysts, and the SEC. The SEC began an investigation of Enron. About this same time an internal whistleblower, Enron Executive, Sherron Watkins, who was not a part of the accounting schemes, became concerned and wrote a letter to Enron's CEO and Chairman, Kenneth Lay, warning him of an impending accounting scandal. Lay took the letter to his legal counsel, which ultimately led to an independent investigation of the alleged fraudulent activities and, with the SEC investigation, led to the downfall and bankruptcy of Enron.

## WorldCom – 2002

Through 2002, WorldCom was the largest fraud in U.S. history, even larger than Enron. However, unlike Enron, which created very complex fraudulent financial transactions and complex fraudulent financial statements; WorldCom's fraudulent entries were very simple. WorldCom recorded certain debits that should have been recorded as expenses, as assets; fraudulently increasing revenues, assets, and net owners' equity. WorldCom also created very simple, fraudulent revenue entries at the end of any quarter when additional revenue was needed to "make the numbers" analysts were expecting.

WorldCom's fraud was led by its CEO, CFO, controller and director of accounting. The fraud was uncovered by an internal whistleblower, Cynthia Cooper, vice president of internal audits.

## Lehman Brothers – 2008

Through 2008, Lehman Brothers is the largest bankruptcy filing in the U.S. The bankruptcy filing was caused by Lehman Brothers' inability to meet cash requirements. As a part of the bankruptcy filings, an investigation was conducted to find what caused Lehman Brothers' liquidity problems. It was this investigation, by a skilled fraud investigator, that uncovered the accounting fraud.

The fraud was fairly simple and similar to the other cases we have examined. Lehman Brothers' executives were under pressure to reduce leverage by raising cash and reducing debt. The company had assets it could not sell, but that it could borrow against in a "repo" transaction in which it used the assets as collateral with the proper accounting to leave the assets on the book and show the borrowing against those assets as debt. Lehman Brothers used fraudulent accounting showing the transaction as a sale of the assets, removing the assets from the books and failing to record the debt. The problem was further compounded when the money borrowed was used to pay off other debt, leaving no money to pay off the new, unrecorded debt - a scheme that was doomed to failure in a recessionary economy and one that did collapse with Lehman being forced into bankruptcy. Again, we have top management directing fraudulent accounting entries in a scheme to under-report company debt the same type of frauds committed before SOX that SOX was supposed to discourage.

As a result of Lehman Brothers and other similar poor business decisions and fraudulent reporting during the 2008 recession, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) was passed. Dodd-Frank's primary emphasis is on regulations of financial securities and financial institutions creating or changing various regulatory agencies, requiring numerous studies and rule making. However, Dodd-Frank also addresses corporate governance and executive compensation of all publicly held companies.

## Groupon - 2012

Five months after going public, Groupon announced a "material weakness" in internal controls which had resulted in a revision in its fourth quarter financial results from losses of \$42.3 million to \$64.9 million, which then resulted in a 6 percent decrease in its share price. In the five months since it went public, Groupon's shares fell by 30 percent . It is unclear who was responsible for the "material weaknesses" but the auditors disclosed the weakness and blamed the company, while the company blamed the auditors for not identifying the material weaknesses earlier.

One thing to note regarding Groupon's problems is that while SOX requires disclosures of "material weaknesses" in quarterly and annual reports to the SEC, SOX does not require disclosure of control weaknesses in a company's Initial Public Offering (IPO).



## About the Authors

**Dale Wallis** retired as Vice President, Chief Financial Officer, and Treasurer for The Aerospace Corporation in 2011. Prior to Aerospace Wallis spent many years as an auditor with two of the Big 4 CPA firms, a partner in a local CPA practice, and in internal audits and corporate financial management at both publicly and privately held corporations. In all of these roles, Wallis was responsible for assessing and implementing internal controls and risk management. Wallis began his career over 40 years ago as an auditor and on his second assignment helped detect a fraud scheme perpetrated by the client company president's son-in-law. From that beginning, Wallis developed an interest in what caused "good people" to commit fraud. Throughout his career Wallis has helped detect many frauds at audit clients and at companies where he was in financial management. In addition, Wallis has taught accounting and auditing at several major universities over his career and currently teaches Ethics in Accounting for UCLA Extension.

The author of this study first became interested in the cycle of fraud and the ineffectiveness of legislation and regulations to reduce fraud after meeting one of the authors of a study done by the Financial Executives Research Foundation (FERF) in 1980.<sup>20</sup> The 1980 study was 445 pages long and included surveys and research to report on the findings on the state of the art of internal control in U.S. corporations and the impact of the Foreign Corrupt Practices Act with respect to internal control. The author of the 1980 study commented on how Sarbanes Oxley, COSO, and all the other legislation and regulations since 1980 were basically attempting to solve the same problems described in the 1980 report and that none had succeeded.

Wallis is a CPA and an active member of Financial Executives International (FEI) where he has served on the national board and in several leadership positions both nationally, locally. He is a member of FERF's research committee.

**Leena Roselli** is Senior Manager, Research at FERF. She received her Master's of Business Administration degree from the Saint Peter's University. Prior to joining FERF, Leena held technical accounting research positions in the pharmaceutical, insurance and retail industries. She can be reached at [lroselli@financialexecutives.org](mailto:lroselli@financialexecutives.org) or 973-765-1039.

---

<sup>20</sup>Mautz, Kell, Maher, Merten, Reilly, Severance, and White; *Internal Control in U.S. Corporations, A research study and report prepared for the FINANCIAL EXECUTIVES RESEARCH FOUNDATION*, (New York, NY: Financial Executives Research Foundation. 1980).

# About RR Donnelley Financial Services

A Fortune 300 company, RR Donnelley is a global provider of financial disclosure solutions, helping our clients efficiently meet their regulatory obligations and streamline their SEC reporting process. With a global network of service professionals and innovative technology, RR Donnelley is uniquely positioned to assist companies with all of their financial communications needs. RR Donnelley provides:

- **EDGAR Filing Expertise** - Handling more than 130,000 SEC filings annually - 10-K, 10-Q, DEF14A, 8-K, S-1, S-4, S-3 – more than any other filing agent
- **XBRL Filing Experience** - Tagging more than 45,000 SEC filings to date, including transactional registration statements requiring XBRL
- **Deal Leadership** - Bringing the world's largest financial transactions to market – IPOs, merger acquisitions, bankruptcy/restructuring, leveraged buyout transactions
- **Venue® Virtual Data Rooms**- Providing secure document storage – facilitating Regulatory Compliance activities, M&A Due Diligence, Fundraising & LP reporting, Board of Director communications and IPOs
- **ActiveDisclosure** - Built around Microsoft Office® productivity tools, RR Donnelley's comprehensive disclosure management solutions works the way you do.
- **Proxy Solutions** – Delivering proxy statement design, production and filing as well as end-to-end annual meeting services to over 1,900 US companies annually
- **Extensive Distribution Network** - Delivering content across 14 time zones, 4 continents, and nearly 40 countries
- **Financial Stability** - A \$10.6 billion Fortune 500 company founded in 1864

For more information, visit:

[financial.rrd.com](http://financial.rrd.com)

RR DONNELLEY

[activedisclosure.com](http://activedisclosure.com)

RRD  
ActiveDisclosure<sup>SM</sup>

[venue.rrd.com](http://venue.rrd.com)

RR DONNELLEY

VENUE

# About Financial Executives Research Foundation

Financial Executives Research Foundation (FERF) is the non-profit 501(c)(3) research affiliate of Financial Executives International (FEI). FERF researchers identify key financial issues and develop impartial, timely research reports for FEI members and non-members alike, in a variety of publication formats. FERF relies primarily on voluntary tax-deductible contributions from corporations and individuals. Questions about FERF can be directed to [bsinnett@financialexecutives.org](mailto:bsinnett@financialexecutives.org). The views set forth in this publication are those of the author and do not necessarily represent those of the FERF Board as a whole, individual trustees, employees, or the members of the Research Committee. FERF shall be held harmless against any claims, demands, suits, damages, injuries, costs, or expenses of any kind or nature whatsoever except such liabilities as may result solely from misconduct or improper performance by the Foundation or any of its representatives. FERF publications can be ordered by logging onto <http://www.ferf.org>.

Copyright © 2015 by Financial Executives Research Foundation, Inc.  
All rights reserved. No part of this publication may be reproduced in any form or by any means without written permission from the publisher.

International Standard Book Number  
978-1-61509-176-8  
Printed in the United States of America

First Printing

Authorization to photocopy items for internal or personal use, or the internal or personal use of specific clients, is granted by Financial Executives Research Foundation, Inc. provided that an appropriate fee is paid to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923. Fee inquiries can be directed to Copyright Clearance Center at (978) 750-8400. For further information, please check Copyright Clearance Center online at <http://www.copyright.com>.

Cover Illustration: ©Rogotanie/iStock/Thinkstock



**Financial Executives Research Foundation (FERF) gratefully acknowledges these companies for their longstanding support and generosity**

**PLATINUM MAJOR GIFT | \$50,000 +**

Exxon Mobil Corporation      Microsoft Corporation

**GOLD PRESIDENT'S CIRCLE | \$10,000 - \$14,999**

Cisco Systems, Inc.  
 Cummins Inc  
 Dow Chemical Company  
 General Electric Co  
 Wells Fargo & Company

**SILVER PRESIDENT'S CIRCLE | \$5,000 - \$9,999**

Apple, Inc.	Johnson & Johnson
The Boeing Company	Lockheed Martin, Inc.
Comcast Corporation	McDonald's Corporation
Corning Incorporated	Medtronic, Inc.
Credit Suisse AG	Motorola Solutions, Inc.
Dell, Inc.	PepsiCo, Inc.
Dupont	Pfizer Inc.
Eli Lilly and Company	Procter & Gamble Co.
GM Foundation	Sony Corporation of America
Halliburton Company	Tenneco
The Hershey Company	Tyco International Mgmt Co.
IBM Corporation	Wal-Mart Stores, Inc.

**GOLD CORPORATE LEADERSHIP - \$2,500 - \$4,999**

Accenture LLP	Raytheon, Inc.
Aetna, Inc	Select Medical Corp.
Intel Corporation	Time Warner, Inc.
Precision Castparts Corp.	United Technologies Corporation

**SILVER CORPORATE LEADERSHIP - \$1,000 - \$2,499**

American Financial Group, Inc.	OMNOVA Solutions, Inc.
Barnes Group, Inc.	Paychex
Edward Jones	Scripps Networks Interactive, Inc.
Graham Holdings	Telephone and Data Systems, Inc.
The J.M. Smucker Company	Trinity Industries, Inc.
McCormick & Company, Inc.	