The Fraud Control Gap: Compliance & Ethics Implications

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How the “fraud control gap” impacts compliance & ethics

• Fraud controls share key elements with compliance and ethics programs
• These elements need to be strong for both fraud controls and compliance & ethics programs to be strong
• Our survey results suggest most organizations have opportunities to enhance their fraud controls, including several shared elements
• New fraud guidance may increase scrutiny from audit committees, boards of directors and others
• Compliance and ethics officers can anticipate this issue and help their organizations enhance performance
## Agenda

- The elements of the “fraud control gap”
- Implications for the effectiveness of compliance & ethics programs
- Potential impact on your organization
- Key areas to target for evaluation
- Using the study results to obtain greater management and board support

## Fraud control – why a concern now?

Reasons include:
- Continuing incidents of fraud
- Increased diversity of anti-fraud practices
- Some uncertainty about performance vs. peers
- SEC guidance and PCAOB AS 5 taking effect
- New guidance issued 7/7/08 by IIA, AICPA & ACFE
  
  - Managing the Business Risk of Fraud: a practical guide (hereafter “MTBF”)
Deloitte Forensic Center study

- Survey of 277 executives involved in fraud control
- Broad range of industries and company sizes
- 64% of respondents subject to SOX
- Respondents grouped based on average scores on four initial questions
  - 41% deemed “more effective” at fraud control
  - 59% deemed “less effective”
- Compared responses for the two groups

1. Executives at more effective companies gave their companies far higher ratings on all aspects of fraud control

<table>
<thead>
<tr>
<th>Effectiveness of Fraud Control</th>
<th>More effective companies</th>
<th>Less effective companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preventing internal fraud</td>
<td>21%</td>
<td>92%</td>
</tr>
<tr>
<td>Detecting internal fraud</td>
<td>17%</td>
<td>93%</td>
</tr>
<tr>
<td>Training employees on fraud</td>
<td>12%</td>
<td>58%</td>
</tr>
<tr>
<td>Communicating to vendors and business partners about fraud</td>
<td>10%</td>
<td>50%</td>
</tr>
<tr>
<td>Preventing external fraud</td>
<td>5%</td>
<td>58%</td>
</tr>
<tr>
<td>Detecting external fraud</td>
<td>4%</td>
<td>56%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
1. Potential implications for compliance & ethics

- The survey results suggest most organizations have opportunities to enhance their fraud controls.
- Would your organization be in the “more effective” minority?
- Is your organization “very effective” in preventing and detecting external fraud as well as internal fraud?

2. Executives at more effective companies anticipated that instances of fraud were much less likely to occur over the next 12 months

<table>
<thead>
<tr>
<th>Likelihood of Types of Fraud over Next 12 Months</th>
<th>Percent of Companies Responding that Fraud is Somewhat, Very, or Extremely Likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Misappropriation of assets</td>
<td>More effective companies: 38%</td>
</tr>
<tr>
<td>Self-dealing</td>
<td>More effective companies: 27%</td>
</tr>
<tr>
<td>Improper expenditures</td>
<td>More effective companies: 24%</td>
</tr>
<tr>
<td>Prettexting</td>
<td>More effective companies: 10%</td>
</tr>
<tr>
<td>Fraudulent reporting</td>
<td>More effective companies: 9%</td>
</tr>
<tr>
<td>Violations of law in foreign activities</td>
<td>More effective companies: 8%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
2. Potential implications for compliance & ethics

- This data can help to make the business case for enhancing fraud control and compliance and ethics program elements; it helps to show potential return on investment (ROI)
- Reducing the likelihood of fraudulent reporting and FCPA violations may be particularly attractive to your board of directors and/or audit committee
- What are your expectations about future incidents of fraud at your organization?
- Could raising the performance of fraud controls reduce the likelihood of fraud at your organization?

3. At more effective companies, senior executives—especially the CEO—were much more likely to be very involved in fraud control

<table>
<thead>
<tr>
<th>Involvement of Executives in Fraud Control</th>
<th>Percent of Companies Responding “Very Involved” (4 – 5 on 5-point scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CCO</td>
<td>More effective companies: 93% Less effective companies: 65%</td>
</tr>
<tr>
<td>CFO</td>
<td>More effective companies: 79% Less effective companies: 51%</td>
</tr>
<tr>
<td>CRO</td>
<td>More effective companies: 76% Less effective companies: 53%</td>
</tr>
<tr>
<td>General Counsel</td>
<td>More effective companies: 74% Less effective companies: 50%</td>
</tr>
<tr>
<td>CEO</td>
<td>More effective companies: 57% Less effective companies: 24%</td>
</tr>
<tr>
<td>COO</td>
<td>More effective companies: 56% Less effective companies: 25%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
3. Potential implications for compliance & ethics

- Are your organization’s senior management most effectively involved in fraud control?
- How could their involvement be enhanced?
  - Greater focus on goal-setting, assigning responsibilities and performance measurement?
- Are those charged with governance effectively overseeing management and the fraud risk management process?
  - See MTBRF guidance on fraud risk governance
- How can you help drive appropriate involvement of senior management and those charged with governance?
  - Different issues motivate different companies/industries

4. More effective companies were much more likely to have a formal fraud control policy/strategy

<table>
<thead>
<tr>
<th>Does Company have Formal Fraud Control Policy/Strategy?</th>
</tr>
</thead>
<tbody>
<tr>
<td>No, and no plans, 18%</td>
</tr>
<tr>
<td>No, but plan to, 32%</td>
</tr>
<tr>
<td>More effective companies, 62%</td>
</tr>
<tr>
<td>Less effective companies, 41%</td>
</tr>
</tbody>
</table>

Of those responding “yes”, the breakdown was:

Source: Deloitte Forensic Center Survey, 2007
4. Potential implications for compliance & ethics

- Does your organization have a formal fraud control policy or strategy in place?
- How comprehensive is the fraud control policy or strategy?
- How can you assist management in drafting or improving on the organization’s formal fraud control policy or strategy?
- MTBRF has a sample framework and a sample policy

5. The fraud control policy/strategy at more effective companies was much more likely to address specific types of fraud

<table>
<thead>
<tr>
<th>Types of Fraud Addressed “Extensively” in Fraud Control Policy/Strategy</th>
<th>More effective companies</th>
<th>Less effective companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Misappropriation of assets</td>
<td>83%</td>
<td>54%</td>
</tr>
<tr>
<td>Improper expenditures</td>
<td>75%</td>
<td>60%</td>
</tr>
<tr>
<td>Self-dealing</td>
<td>71%</td>
<td>49%</td>
</tr>
<tr>
<td>Fraudulent reporting</td>
<td>77%</td>
<td>40%</td>
</tr>
<tr>
<td>Violations of law in foreign activities</td>
<td>70%</td>
<td>39%</td>
</tr>
<tr>
<td>Pretexting</td>
<td>49%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
5. Potential implications for compliance & ethics

- How detailed is your organization’s fraud control policy or strategy?
- Does the fraud control policy or strategy address specific types of fraud?
  - Would addressing specific types of fraud enhance your organization’s fraud control policy/strategy?
  - Are your organization’s greatest fraud risk exposures addressed in your fraud control policy/strategy?
  - Consider comparing the policy/strategy with the fraud risk assessment to see if they are aligned on key risks.

6. More effective companies were much more likely to report that their fraud risk assessments contained key features

Characteristics of Formal Fraud Risk Assessments
Percent of Executives who “Agree Strongly”
Base=Companies Conducting Fraud Risk Assessments

<table>
<thead>
<tr>
<th>Feature</th>
<th>More effective companies</th>
<th>Less effective companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Follow risk-based assessment</td>
<td>60%</td>
<td>79%</td>
</tr>
<tr>
<td>Risks linked to control activities</td>
<td>52%</td>
<td>79%</td>
</tr>
<tr>
<td>Personnel of all levels involved</td>
<td>40%</td>
<td>59%</td>
</tr>
<tr>
<td>Overrides examined</td>
<td>31%</td>
<td>63%</td>
</tr>
<tr>
<td>Good job of considering fraud scenarios</td>
<td>30%</td>
<td>60%</td>
</tr>
<tr>
<td>Assessments conducted for business units</td>
<td>38%</td>
<td>54%</td>
</tr>
<tr>
<td>Assessments conducted for countries</td>
<td>28%</td>
<td>50%</td>
</tr>
<tr>
<td>Detailed assessments</td>
<td>23%</td>
<td>43%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
6. Potential implications for compliance & ethics

- Does your organization have a formal fraud risk assessment?
- How effective do you think it is?
  - Do fraud risks identify specific scenarios and perpetrators?
  - Are management overrides fully addressed?
  - Are the risks linked to relevant control activities?
  - Does it cover significant business units, countries and accounts?
- How could your fraud risk assessment be made more effective?
- Consider comparing the risk assessment process and framework to those described in MTBRF

7. The whistle-blower hotline at more effective companies was twice as likely to be considered very effective

Existence of Whistle-Blower Hotline

Effectiveness of Whistle-Blower Hotline
Percent “Very Effective” (4 – 5 on 5-point scale)
Base=Companies with Whistle-Blower Hotline

Of those responding “yes”, the breakdown was:

- All companies: 32%
- More effective companies: 46%
- Less effective companies: 22%

Source: Deloitte Forensic Center Survey, 2007
7. Potential implications for compliance & ethics

- According to the ACFE, tips are the number one way in which frauds are detected
  - Potential impact of an under-performing helpline/hotline
- How do you assess the performance of your helpline/hotline?
  - Use of benchmarking tools
  - Are reports within industry norms for volume and type?
  - How does usage compare by operating unit?
- Compare hotline process to recommendations in MTBRF
  - Internal vs. independent provider
  - Education and communications to encourage use

8. More effective companies are more likely to do a better job of training employees about fraud control

Assessments of Fraud Control
Percent of Companies who Responded “Agree Strongly”

<table>
<thead>
<tr>
<th></th>
<th>All companies</th>
<th>More effective companies</th>
<th>Less effective companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees have clear understanding of responsibilities</td>
<td>34%</td>
<td>54%</td>
<td>20%</td>
</tr>
<tr>
<td>Employees have high awareness</td>
<td>30%</td>
<td>54%</td>
<td>13%</td>
</tr>
<tr>
<td>Senior management has effectively communicated importance</td>
<td>27%</td>
<td>47%</td>
<td>13%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
8. Potential implications for compliance & ethics

- Can your employees tell you what their responsibilities are with respect to fraud control?
- Do they consider it part of their job?
- Is fraud awareness training part of new employee training?
- Is it part of annual refresher/update training?

9. More effective companies are three times as likely to use technology substantially in fraud monitoring

Use of Technology in Fraud Monitoring

<table>
<thead>
<tr>
<th>Percent of Executives Citing Substantial Use (4 – 5 on a 5-point scale)</th>
<th>Percent of Executives Saying increased Use of Technology over Next 12 Months was Extremely or Very Likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>All companies</td>
<td>All companies</td>
</tr>
<tr>
<td>More effective companies</td>
<td>More effective companies</td>
</tr>
<tr>
<td>Less effective companies</td>
<td>Less effective companies</td>
</tr>
<tr>
<td>12%</td>
<td>28%</td>
</tr>
<tr>
<td>35%</td>
<td>34%</td>
</tr>
</tbody>
</table>

Source: Deloitte Forensic Center Survey, 2007
9. Potential implications for compliance & ethics

- Does your organization have technology in place that would enable and support fraud monitoring?
- Is technology focused on the most significant fraud risks?
- What uses of technology may become more attractive?
  - Revenue recognition testing
  - Journal entry testing
  - Expense testing
  - Anti-money laundering
  - FCPA and other bribery/corruption monitoring

10. Roughly half the executives reported an increase in resources devoted to fraud, with increased publicity the reason cited most often

**Change in Resources Devoted to Fraud over Last 12 Months**

- Increased, 48%
- Decreased, 3%
- Stayed the same, 49%

Of those who responded "increased", the breakdown was:

- **Reasons for Increase**
  - Base=Companies with Increase

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased publicity on fraud</td>
<td>54%</td>
</tr>
<tr>
<td>Pressure from Board</td>
<td>32%</td>
</tr>
<tr>
<td>Recent fraud instance</td>
<td>31%</td>
</tr>
<tr>
<td>Other</td>
<td>34%</td>
</tr>
</tbody>
</table>

Percentages do not total to 100 since executives could make multiple selections.

Source: Deloitte Forensic Center Survey, 2007

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10. Potential implications for compliance & ethics

- Is your antifraud spending linked to organizational objectives?
- How might publicity about fraud at your organization impact the organization’s reputation?
- What are the implications of loss of reputation?
- Does your organization need to devote more resources to fraud control in order to achieve its objectives?
- MTBRF represents new fraud risk guidance for a new fraud risk environment; re-assessment of resources allocated to managing fraud risk would be prudent

Potential impact on your organization

- Most organizations have opportunities to improve performance in fraud control
- These issues may impact the performance of compliance and ethics programs
- Strengthening these areas can benefit compliance and ethics programs as well as fraud controls
Key areas to target for evaluation

- Key areas recommended for focus include:
  - Fraud risk assessment
  - Fraud control policy/strategy
  - Hotline benchmarking
  - Employee fraud awareness training

Using the study results to build support

- Discuss the potential implications of the study results for your organization
- Assess the potential impact on your compliance and ethics program as well as your fraud controls
- Identify the benefits and value of addressing this proactively
- Build management support to tackle selected areas, raising performance to reflect practices recommended by the SEC and in MTBRF
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